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**THE DESIGN OF MICRO
CREDIT CONTRACTS
AND
MICRO ENTERPRISE FINANCE
IN UGANDA**

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Winifred Tarinyeba Kiryabwire
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PREFACE

This book is an updated version of my doctoral thesis titled “The Design of Micro Credit Contracts and Costs of Credit: A Case Study of Micro Enterprise Finance in Uganda.” The study was conducted between 2006 and 2009 and subsequently updated in 2010.

Several factors affect the efficient performance of credit markets. Uganda, like any other least developed country, has a credit market characterized by what economists call “market imperfections” that affect access to credit. These imperfections can broadly be summarized as information asymmetry and moral hazard. Their effects on the functioning of credit markets vary from one jurisdiction to another. In most developing countries, efforts to improve access to credit have largely focused on lending techniques in which contracts are structured in such a way as to overcome the credit market frictions ordinarily faced by lending institutions. Microfinance has been heralded for its use of innovative lending methods to improve access to credit. The last decade has witnessed an unprecedented increase in the outreach of micro lending institutions and the development of financial products suited to the needs of the economically active poor who often are unable to obtain credit from mainstream financial institutions such as commercial banks.

This book seeks to establish why, despite measures aimed at improving access to micro credit, the majority of micro enterprises in Uganda opt for informal rather than formal sources of credit. I present the results of an empirical investigation involving 602 micro enterprises located in various parts of Uganda and 105 lending institutions. The findings show that despite innovative contractual arrangements designed to enable micro lenders mitigate the problems of adverse selection and moral hazard, there are several factors that continue to hinder micro enterprise access to credit.

Factors such as the evolving nature of micro credit lenders, the lack of flexibility in structuring micro loans, the negative perceptions about loan applicant screening processes, the harsh expected consequences of default, the disincentives of contingent credit and the blind sanctioning of default, impede micro enterprise access to formal credit. Therefore, unless addressed, informal credit will continue to play a more significant financing role than formal credit.

DEDICATION

To the memory of:

My son William Hezzy Kiryabwire, born prematurely at 29 weeks on 27th
March 2008 and passed away on 29th March 2008

and

My father Hezzy K. Tarinyeba who was brutally killed on 10th September 1981

ACKNOWLEDGMENTS

I thank God for leading me through both the good times and the many challenges that I encountered while undertaking my doctoral studies. It is only by His grace that I steadily progressed to the end.

I thank my Professors at Stanford Richard Craswell, G. Marcus Cole, Peter Blair Henry and Deborah R. Hensler for their invaluable guidance.

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There are several people that I need to thank in a special way including my JSD colleagues at Stanford, Muffie, Lucy, Marketa, Gary, Heidi, Louise, Kelsey, Dr. Kibuuka, Mr. Katarikawe, Dr. Ntayi, Baguma, Royi, Anne, Miriam, Baswali, Saaka, Edmund, and the Ugandan friends at Stanford for their support.

Last but not least, I thank the wonderful family that I am blessed to have. My husband, Geoffrey and Daughter Kirabo—thank you for being caring and loving. My mother (Mrs Ida K. Tarinyeba) always encouraged me to aim higher in life and gave me all the emotional and financial support I needed to achieve my goals. My siblings (Hope, David and Emmanuel) have been my cheer leaders throughout the entire process. A special thank you to my in-laws, especially Lydia and my niece Mbabazi, for your love and prayers.

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LIST OF ABBREVIATIONS

ASCA.....	Accumulating Savings and Credit Association
GTZ.....	Gesellschaft für Technische Zusammenarbeit (German Technical Cooperation)
IFC.....	International Finance Corporation
MDI.....	Microfinance Deposit Taking Institution
MFI.....	Microfinance Institutions
MSME.....	Micro, Small and Medium Enterprises
ROSCA.....	Rotating Savings and Credit Association
SACCO.....	Savings and Credit Cooperative
SCS.....	Savings and Credit Society
SIDA.....	Swedish International Development Agency
SME.....	Small and Medium Enterprise
VSLA.....	Village Savings and Loan Association
UGHS.....	Uganda Shillings
KSHS.....	Kenya Shillings
TZHS.....	Tanzania Shillings

CHAPTER ONE

1.0 ACCESS TO MICRO CREDIT IN UGANDA.

1.1 INTRODUCTION

Uganda, like any other low income country, has a credit market characterized by what economists call “market imperfections” that affect access to credit. These imperfections can broadly be summarized as information asymmetry and moral hazard. The former exists due to lack of creditor information, and the latter, a weak environment for contract enforcement. Illustrating the magnitude of the problem, Hernando De Soto says “Imagine a country where nobody can identify who owns what, addresses cannot be easily verified, people cannot be made to pay their debts....”¹ Both information asymmetry and moral hazard exist in most credit markets but to varying degrees. Some scholars have suggested that although disaggregating the effects of each is difficult, in some markets, evidence suggests that the effects of one may be more pronounced than the other. For example, a field experiment in the South African consumer credit market revealed strong evidence that repayment burden was associated with moral hazard rather than with adverse selection effects.²

The extent to which both information asymmetry and moral hazard affect the functioning of credit markets is a rule of law issue. In countries characterized by well functioning legal systems, the problems are not as pronounced as in those where the mechanisms for enforcement of contracts, property verification and ownership are weak. Commenting on the importance of information, De Soto says;

One important reason why the Western formal property system works like a network is that all the property records; (titles, deeds, securities, and contracts that describe the economically significant aspects of assets) are continually tracked and protected as they travel through time and space. Their first stop is the public agencies that are the stewards of an advanced nation's representations. Public record keepers administer the files that contain all the economically useful descriptions of assets.... These files will alert anyone eager to use an asset about things that may restrict or enhance its realization, such as encumbrances, easements, leases, arrears, bankruptcies and mortgages.³

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- 1 Hernando De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, 15 (2000).
 - 2 Dean Karlan & Jonathan Zinman, *Observing Unobservables: Identifying Information Asymmetries with a Consumer Credit Field Experiment*, 77(6) *Econometrica*, 1993 (2009).
 - 3 Hernando De Soto, *supra* note 1 at 61

Studies have shown that when credit market imperfections affect the cost and availability of credit, the smaller economic players have the most difficulty accessing credit.⁴ Therefore, in countries such as Uganda where the majority of economic players are micro enterprises, the effects on access to credit are more pronounced. Although business activity may be financed by either formal or informal credit, this book focuses on access to formal credit. I am, however, mindful of the role of informal credit in enterprise finance, particularly trade and supplier credit, credit obtained through networks, and credit from friends and family. I also acknowledge lending methods used by informal credit providers to overcome some of the classical problems faced by formal credit providers in developing and poor economies such as Uganda are. These methods include reputation, repeated interaction, ostracism and contract renegotiation to accommodate temporary or seasonal difficulties in meeting contractual obligations. Informal credit can play a significant financing role, particularly where formal credit is inaccessible. However, reliance on informal finance has its shortcomings including its inability to extend credit beyond the realms of impersonal exchange and to those who cannot access it through network effects. In addition, according to early theories advanced by development economists such as Joseph Schumpeter, formal credit is better positioned to influence efficient allocation of resources through “creative destruction.”⁵

Suppliers of credit in Uganda include formal, semi-formal and informal lenders. In the first category are financial institutions that are both formally incorporated and regulated by government agencies, including commercial banks, development banks, credit institutions and microfinance deposit taking institutions. Semi-formal lenders include institutions that are formally incorporated either as limited liability companies or as companies limited by guarantee but which are not subjected to any form of prudential regulation. Semi-formal lenders include non-deposit taking microfinance institutions, savings and credit co-operatives and non-governmental organizations involved in credit delivery. Informal institutions are neither formally constituted nor regulated and include Rotating Savings and Credit Societies (ROSCAS), Accumulating Savings and Credit Associations (ASCAS), money lenders, local grocery stores and other sources of informal credit.

Over the years, the Government of Uganda has been to some extent involved in credit delivery, through programs such as the 1961 co-operative credit scheme that provided agricultural inputs on credit to farmers, the 1964 progressive loan scheme that provided partially guaranteed loans to farmers, the 1994 poverty alleviation

4 Thorsten Beck, Asli Demircuc-Kunt & Vojislav Maksimovic, *Financial and Legal Constraints to Firm Growth: Does Firm Size Matter?* 60 *Journal of Finance* 137, 161-12, 170 (2005). The authors argue that it is the smallest firms that are consistently and most adversely affect by access to credit obstacles.

5 Joseph A. Schumpeter, *Theory of Economic Development*, 102(1883-1950) (Redvers Opie trans, 1934).

Access to Micro Credit in Uganda

project, the 1995 *Entandikwa* (seed capital) credit scheme and the current *boona bagagawale* (prosperity for all) scheme. Some of these programs have registered limited success while others have suffered the pitfalls of government intervention in direct credit delivery, including political interference, mismanagement, and poor project design.⁶

Formal and semi-formal credit institutions in Uganda are largely concentrated in the capital city and urban areas. The limited geographical outreach of financial institutions such as banks makes it difficult to obtain formal credit.⁷ Access to formal sector credit, particularly from commercial banks, is severely constrained. A 2003 evaluation of Uganda's financial sector showed that credit to the private sector was approximately 6% of GDP and was constrained by the under development of the market, as well as structural factors including contract enforcement problems, high transaction costs, the narrow range of assets acceptable as collateral, difficulties in realizing collateral, and information asymmetries that raise the perceived risk of lending, especially in rural areas.⁸ As a result, microfinance is considered a viable solution to the access to credit problem currently faced by both households and small businesses, particularly those that are unable to access credit from the mainstream financial institutions such as commercial banks and credit institutions.

The microfinance sector in Uganda has grown rapidly over the last ten years. It is estimated that as of 2006, there were 741 microfinance institutions with 1,064 microfinance outlets spread across the country as follows: eastern region--157 microfinance institutions and 205 microfinance outlets, central region--201 microfinance institutions and 323 microfinance outlets, western region--318 microfinance institutions and 448 microfinance outlets, and northern region--65 microfinance institutions and 88 microfinance outlets.⁹ Therefore, microfinance

6 For a detailed discussion of state directed credit programs in Uganda, see William Muhumuza, *Credit and Reduction of Poverty in Uganda: Structural Adjustment Reforms in Context*, 129-166, (2007).

7 At the time this study was undertaken, there were 16 commercial banks in Uganda of which 12 were foreign owned and four were locally owned, all with a total branch network of 193 outlets. However, as of September, 2010, the number of licensed commercial banks had increased to 22, out of which 18 were foreign owned. See Bank of Uganda Annual Supervision Report, 8, 64 (2007), (Available at http://www.bou.or.ug/bouwebsite/export/sites/default/bou/bou-downloads/annual_supervision/BSAnnualReport2007.pdf); (http://www.bou.or.ug/bouwebsite/opencms/bou/supervision/financial_institutions.html)

8 Uganda: Financial System Stability Assessment, Including Reports on the Observance of Standards and Codes on Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, Insurance Regulation, Corporate Governance, and Payment Systems, 9, International Monetary Fund Country Report No. 03/97 (April, 2003) (<http://www.imf.org/external/pubs/ft/scr/2003/cr0397.pdf>).

9 Luke Okumu, *Preliminary Results of the Census of Microfinance Institutions in Uganda*, Financial Sector Deepening Project Uganda, July 2006. (http://www.fsdu.or.ug/pdf/Preliminary_Results_Census_of_MFIs_in_Uganda.pdf) (Accessed 3/21/2005). It should be noted that these statistics have not been updated and although the prolonged

institutions have broadened the structure of the credit market in Uganda in terms of diversity of providers, products on the market as well as clientele. Microfinance institutions typically serve low income clients so this has broadened the categories of individuals and business that access credit.

The key contribution of microfinance to access to credit has been the adoption of lending methods designed to mitigate the effects of information asymmetry and moral hazard. These methods include group lending, use of collateral substitutes such as forced savings and joint liability, contingent credit, providing services in a specific geographical location, and lending small amounts that require flexible repayment periods. A key feature of these measures is that they assign the roles and responsibilities of the various parties in a credit transaction to the party who can most effectively and efficiently perform a particular function. For example in group lending, screening, monitoring, and enforcement of contractual obligations is performed by borrowers because they have more information than the lender and are also able to sanction default. The reassignment of roles and implications for access to micro credit is discussed in detail in Chapter six.

Various studies have shown that innovative lending in microfinance has made a substantial contribution to bridging the access to credit gap. In economies such as Uganda, where the majority of commercial enterprises are micro, small and medium enterprises (MSMEs),¹⁰ the “microfinance revolution” appears to be a promising one. In addition, the anecdotes on the contribution of microfinance to poverty alleviation, job creation, and enterprise transformation, seem to suggest that access to credit constraints have largely been overcome. However, there appears to be a missing link. “Innovative lending” in microfinance has, to some degree, enabled lenders to overcome the problems of information asymmetry and moral hazard and therefore, has eased entry into the credit markets for those who would otherwise not be able to access credit. However, there are some persistent costs of credit that still affect access to credit. Micro credit continues to remain an unattractive form of finance for the majority of micro enterprises despite the measures intended to improve access to credit. This book seeks to re-examine micro credit contractual arrangements to determine why micro enterprises are averse to using micro credit to finance their businesses.

insurgency in the northern region may account for the low figures, the number of microfinance and other financial institutions may have changed since the cessation of hostilities between the Lord's Resistance Army and the Government.

10 It is estimated that as of 2001, there were 1,069,848 MSMEs in Uganda employing 90% of the total non-farm private sector works. See Enhancing the Competitiveness of Micro Small and Medium Enterprises in Uganda, (Ministry of Finance, Planning and Economic Development Discussion Paper No. 15 of 2008) (Available at http://www.finance.go.ug/policy_papers.php) (Accesses 9/08/2010).

1.2 RESEARCH PROBLEM AND RESEARCH QUESTIONS

Broadening access to formal credit, particularly for sectors that have historically been rationed out of the mainstream credit market such as MSMEs and poor households, is high on the agenda of many developing and poor countries as well as the World Bank, development and international financial institutions. Various studies have attempted to define and measure cross-country variations in access to credit, identify costs of credit as well as factors that affect those costs. Some of the factors include information asymmetry, poor contract enforcement, poor infrastructure and banks' rational business decisions.¹¹

Efforts to improve access to credit focus primarily on creditor protection. This approach is based on the notion that market imperfections such as information asymmetries and inadequate creditor protection increase the cost of credit which leads to credit market inefficiencies. Therefore, policies to improve access to credit have largely adopted a "creditor rights system". The literature and policy discussions have taken two dimensions – the conventional approach adopted by the World Bank in most developing countries seeks to reduce informational and contractual inefficiencies through legal reforms, strengthening judicial institutions and land registries. The other approach recognizes that in most developing countries, the majority of businesses are MSMEs that are rationed out of the mainstream commercial banking sector. Therefore, micro credit is considered a viable option for increasing access to credit for these types of businesses.

Lending methods used by providers of micro credit have to an extent eased access to credit because of the reduced information gap between lenders and improved enforcement. However, micro enterprises continue to face some costs that make it difficult for them to obtain formal credit. The issue is whether the benefits of eased entry into the credit market, as a result of "innovative lending", sufficiently outweigh the post-credit market entry problems faced by borrowers so as to make it attractive for them to borrow. For example, while group lending may provide access to credit markets for first time borrowers, the high cost of credit, lack of flexibility in determining loan amounts that first time borrowers are eligible to borrow, may discourage potential borrowers from seeking credit. These and other factors may explain the contradictions in micro lending exhibited, on one hand by the increased outreach of micro credit institutions, high repayment rates, product development and eased entry into the credit market but informal

11 Thorsten Beck, Asli Demirguc-Kunt & Maria Soledad Martinez Peria, *Banking Services For Everyone? Barriers to Bank Access and Use Around the World*, (World Bank Policy Research Working Paper No. 4079, 2007) (Available at <http://go.worldbank.org/KXNIZEVDB0>).

credit markets persistently crowding out of formal credit markets on the other hand.

1.2.1 Research Questions

In light of the problem described above, I will seek to address the following research questions:

- (1) How do micro enterprises in Uganda finance their businesses?
- (2) What are the determinants of financing decisions of micro enterprises?
- (3) Why, despite “innovative lending” methods in microfinance, do micro enterprises access to credit barriers?

1.3 MOTIVATION FOR THE STUDY

The issue of small business finance has largely been discussed within the context of small and medium enterprises (SMEs).¹² The rationale for this is that although in most economies SMEs significantly contribute to economic growth and employment creation,¹³ they have traditionally faced higher obstacles to accessing external finance than other groups such as large enterprises and consumers.¹⁴ The policy discussions and the literature have contributed significantly to the understanding of the financing constraints of SMEs. However, micro enterprises have not received as much attention and yet for poor countries such as Uganda, they are succinctly distinct from SMEs but important as far as livelihoods and self-employment are concerned. Because the majority of the non-farming active population in Uganda is employed by micro enterprises, access to micro credit is critical for the growth of this sector.

The issue of micro enterprise access to credit is important for several reasons:

- (i) the economic and self-employment role of micro enterprises in poor countries,
- (2) the inability of financial market reforms such as financial sector liberalization to significantly improve access to micro credit,¹⁵
- (3) the mistaken assumption that

12 There is a vast body of literature on SME finance and SME financing constraints. Notably, in May 2008, the World Bank held a conference on small business finance that brought together academics, practitioners, and policy makers to discuss lending techniques and products for small enterprises, market structure and small enterprise financing, government roles in fostering small firms' access to finance and alternatives to bank finance. (See <http://go.worldbank.org/9E6LG7ZI70>).

13 Kristin Hallberg, *A Market Oriented Strategy for Small and Medium-Scale Enterprises*, (IFC Discussion Paper 40, 2000) (Stating that for both high income and low income countries, SMEs make a significant contribution to total employment and GDP).

14 Thorsten Beck, Asli Demirguc-Kunt Luc Leaven & Vojislav Maksimovic, *The Determinants of Financing Obstacles*, 25 Journal of International Money and Finance 932 (2006) (arguing that access to finance is a major obstacle to SME growth).

15 Thorsten Beck & Augusto de la Torre, *The Basic Analytics of Access to Financial Services*, 16 Financial Markets, Institutions and Instruments 79 (2007).

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certain categories of businesses do not need credit, and (4) the failure of “innovative lending strategies” to solve the credit constraints faced by micro enterprises. Although it is generally known that small firms face higher financing obstacles than larger firms,¹⁶ the financing constraints peculiar to micro enterprises have not received much attention. In addition, while there is evidence that lending methods used in microfinance can improve access to credit for firms such as micro enterprises, it is not clear why they are reluctant to use micro credit.

Prior work on access to credit in Uganda includes national surveys on access to credit.¹⁷ With regard to micro credit, there has been work on micro credit and poverty alleviation,¹⁸ a review of the performance of the microfinance sector,¹⁹ integration of microfinance institutions and mainstream financial institutions,²⁰ regulation of micro credit providers particularly Tier 4 microfinance institutions,²¹

16 A study of SMEs across the globe revealed that. Meghana Ayyagari, Thorsten Beck & Asli Demirgüç-Kunt, *Small and Medium Enterprises Across the Globe*, 29 *Small Business Economics*, 415 (2007) (reporting on a study that revealed that small firms face significantly higher financing obstacles than medium firms. In addition both small and medium firms face higher financing obstacles than large firms).

17 Finscope Uganda, Results of a National Survey on Access to Financial Services in Uganda, 2007 (http://www.fsdu.or.ug/pdfs/Finscope_Report.pdf); Uganda Bureau of Statistics Report on the Economic Module: Results of the Uganda National Household Survey 2005/06; UBOS/NEPAD, Report on the National Household Sample Survey, 2007. (Both surveys indicate that access to formal credit is severely constrained and the majority of Ugandans obtain credit from informal sources).

18 See Irmi Hanak, “*Working Her Way out of Poverty*”: *Micro-Credit Undelivered Program’s Undelivered Promises in Poverty Alleviation*, 16 *Journal für Entwicklungspolitik* 303, 325 (2000) (arguing that although microfinance institutions provide important services for clients neglected by the formal banking sector and the institutions exhibit highly positive records in terms of financial sustainability, growing number of clients and improved payment rates, there are severe short-comings with regard to the realization of social development objectives); William Muhumuza, *Unfulfilled Promises? NGO’s Micro-Credit Programs and Poverty Reduction In Uganda*, 23 *Journal of Contemporary African Studies* 391 (2005) (arguing that although NGOs managed to fill the vacuum caused by neglect of the poor in remote parts of Uganda by formal financial institutions and Government, their credit programs have not necessarily translated into meaningful economic empowerment. See also William Muhumuza, *Credit and Reduction of Poverty in Uganda: Structural Adjustment Reforms in Context*, 2007 (arguing that although credit contributes to poverty reduction, its effectiveness may be undermined by wider socio-economic factors such as local cultural impediments, inadequate markets, macro-economic policies as well as the design and mechanism through which credit is made available).

19 Ruth Goodwin, Till Bruette & Alexia Latortue, *Uganda Microfinance Sector Effectiveness Review*, CGAP Publication, 2004, (Available at http://www.cgap.org/gm/document-1.9.2189/clear_uganda_report.pdf) (The review highlighted the need to improve rural access to financial services).

20 Rani Deshpande, Mark Pickens & Hermann Messan, *Uganda: Country Level Savings Assessment*, CGAP Publication, 2006 (Available at http://www.cgap.org/gm/document-1.9.2922/uganda_assessment.pdf) (The report suggests integration of microfinance institutions with mainstream financial institutions as a means a means of ensuring secure deposit services for the poor).

21 Justin Nanyonjo & James Nsubuga, *Recognizing the Role of Microfinance Institutions in Uganda* (Bank of Uganda Working Paper 04/01, 2004) (discussing the growing importance of microfinance to Uganda’s growth strategy as well as identify challenges facing the development of the microfinance industry, including

and assessing the credit needs of enterprises.²² However, some gaps persist such as the issue of micro enterprise access to credit particularly why microenterprises remain disinclined to use formal micro credit. I have attempted to take the discussion on access to credit, particularly the issue of demand for credit, beyond the usual rhetoric that the majority of enterprises in developing countries have no demand for formal credit because they rely on other forms of credit such as trade credit. I will demonstrate the existence of a real need for credit among micro enterprises in Uganda, but I will also show that access is inhibited not by supply constraints, but that for various reasons, the majority of micro enterprises opt not to use formal credit.

1.4 RESEARCH METHODOLOGY

The objective of this research was to establish why micro enterprises opt not to use formal credit despite measures adopted by micro lenders to ease access to credit. The measures are commonly referred to as “innovative lending technologies” and are used in microfinance to overcome the problems of information asymmetry and moral hazard. These problems are prevalent in developing markets where legal and institutional frameworks for the efficient operation of credit markets are weak. The study sought to:

- (1) Establish how micro enterprises in Uganda finance their businesses;
- (2) Ascertain the factors that influence the financing decisions of micro enterprises; and
- (3) Establish why micro enterprises continue to finance their businesses using informal credit despite measures to improve access to micro credit.

The research was essentially a case study of the design of micro credit contracts and the implications for micro enterprise access to credit in Uganda. My research population consisted of selected micro credit institutions and micro enterprises. The methodology for the research is outlined in sections 1.4.1 to 1.6.3.

1.4.1 Empirical Work

The empirical component of the study was primarily qualitative in nature and involved surveys and in-depth unstructured interviews of selected micro credit institutions and micro enterprises. The research was conducted in phases. Phase 1 involved identifying target respondents to standard survey questionnaires –

poor infrastructure, inadequate human resource capacity, lack of regulation for Tier 4 microfinance institutions and political instability in northern Uganda).

22 Okurut, FN, Schommbee A. & Van Der Berg S., *Credit Demand and Credit Rationing in the Informal Financial Sector in Uganda* 73 South African Journal of Economics 482 (2005); Marcel Fafchamps, *Ethnicity and Credit in African Manufacturing*, 61 Journal of Development Economics 205(2000).

one for micro credit institutions and another for micro enterprises. The survey questionnaires for both micro credit lenders and micro enterprises were distributed to respondents in Kampala, and in the central, eastern, western and northern regions of Uganda. The objective was to capture a broad representation of the study population and ensure that any region- specific variations are reflected in the findings.

The survey questionnaire for micro credit lenders was designed to capture the following information from the creditors: the nature, the type, the size and period of operation of the institution, the credit facilities offered, the lending requirements, the tools used to screen and monitor borrowers, the loan recovery rates and the recovery mechanisms in the event of default. On the other hand, the survey questionnaire for micro enterprises required the respondents to provide information on the history, the size and the number of people employed by the business, how the business was financed and any constraints to obtaining formal credit.

Prior to conducting the empirical component of the study, the questionnaires were submitted to the Stanford Research Compliance office for human subjects review. The Institutional Review Board determined that my research was outside the scope of human subjects' research and permitted me to proceed without further review by the Board.

1.5 THE RESEARCH POPULATION

1.5.1 Micro Credit Institutions

As mentioned earlier, the credit market in Uganda consists of formal, semi-formal and informal credit institutions. Commercial banks, development banks, and to a large extent, credit institutions provide credit to the high-end market. Micro credit institutions typically serve the low-end market including micro enterprises. Therefore, for purposes of this research, I focused on formal institutions that provide micro credit, such as microfinance deposit taking institutions and semi-formal institutions such as non-deposit taking microfinance institutions and savings and credit cooperatives. When appropriate, a comparative analysis has been made with other financial institutions.

1.5.2 Micro Enterprises

I first dealt with the issue of defining micro enterprises. In many countries, small and medium enterprises (SMEs) are the drivers of economic growth in terms of employment and productivity. This is not because SMEs are more efficient or

productive than large scale enterprises, but because, particularly within the context of developing countries, economic, financial and other constraints impede firm growth hence the existence of a large SME sector. As some studies have shown, although the size of the SME sector is correlated with GDP per capita growth, the relationship is not causal and may be merely indicative or characteristic of successful economies.²³ However, for the majority of developing countries that have very few large scale enterprises, SMEs are major economic players. The question then is how does one arrive at a definition of characterization of micro, small and medium enterprises? At the time of undertaking the research, there was no concise definition of SMEs in Uganda. Some commentators have argued that although MSMEs are easier to define by their characteristics such as the size of capital investment, number of employees, turnover, style of management and market share, cross country context plays a major role in determining these characteristics.²⁴ The 2007 draft SME policy recommended the following definitions that are yet to be formally adopted by the government:²⁵

- ★ **A Micro enterprise** is defined as an enterprise employing maximum 4 people; annual sales/revenue turnover of maximum Uganda Shillings 12 million and total assets of maximum Uganda Shillings 12 million.
- ★ **A Small Enterprise** is defined as an enterprise employing maximum 50 people; annual sales/revenue turnover of maximum Uganda Shillings 360 million and total assets of maximum Uganda Shillings 360 million.
- ★ **A Medium Enterprise** is defined as an enterprise employing more than 50 people; annual Sales/revenue turnover of more than Uganda Shillings 360 million and total assets of more than Uganda Shillings 360 million.

The standard measure is that these businesses employ 0–250 people.²⁶ This definition is too broad and does not give an accurate description of SMEs in developing countries.

The European Union's criteria for classifying Micro, Small and Medium Enterprises (MSMEs) takes into account factors such as the number of employees, the annual returns and the size of the enterprise.²⁷ Therefore, a micro enterprise

23 Thorsten Beck, Asli Demirguc-Kunt & Ross Levine, *SMEs, Growth and Poverty: Cross-Country Evidence*, 10 Journal of Economic Growth, 197, 216–223 (2005). The same study found that the presence of a large SME sector does not necessarily improve income levels for the poor (at p.223–223).

24 Louis Kasenkende, *Financing SMES: Uganda's Experience*, 97–107, 97, in *Improving the Competitiveness of SMEs in Developing Countries: The Role of Finance to Enhance Enterprise Development*, UNCTAD/ITE/TEB/Misc.3 (2001) (Available at http://www.unctad.org/en/docs/titebmisc3_en.pdf)

25 Commonwealth Secretariat, *UGANDA: Development of a National Micro, Small and Medium Enterprises (SME) Policy and Strategy*, July 2007. Commonwealth Secretariat, London p. 28.

26 Beck, *et al.*, *supra*, note 15

27 *Commission Recommendation Concerning the Definition of Micro- Small and Medium-Sized Enterprises*, at 13–14, COM (2003) 361 final (May, 6, 2003).

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employs less than ten people, has annual returns not exceeding two million Euros, and assets not exceeding two million Euros.²⁸ A small enterprise employs less than 50 people, has annual returns not exceeding ten million Euros, and assets not exceeding ten million Euros.²⁹ A medium enterprise employs less than 250 people, has annual returns not exceeding 50 million Euros and assets not exceeding 43 million Euros.³⁰

The International Finance Corporation (IFC) on the other hand has varying definitions of MSMEs depending on whether they are in a low, middle or high income country.³¹ Therefore, in low income countries, a micro enterprise employs less than 5 people, a small enterprise employs less than 20 people and a medium enterprise employs less than 100 people. In a middle income country, a micro enterprise employs less than 10 people, a small enterprise employs between 10 to 50 people and medium enterprise employs between 50–100 people. In high income enterprises, a micro enterprise employs less than 10 people, a small enterprise employs 50 to 100 people, and a medium enterprise employs less than 500 people.

In 2001, Uganda was estimated to have 1,069,848 enterprises classified as MSMEs and forming 90 percent of Uganda's private sector. MSMEs employ approximately 1.5 million people equivalent to 90% of total non-farm private sector workers.³² For purposes of this research, I focused on selecting small businesses that had the defining characteristics of micro enterprises.

1.6 SELECTION CRITERIA

1.6.1 Micro Credit Institutions

There were four microfinance deposit taking institutions in Uganda, and, as of 2007, there were over 790 microfinance institutions including non-deposit taking microfinance institutions, savings and credit cooperatives, and NGOs engaged in providing micro-credit. There is no single comprehensive register of microfinance institutions. The Gesellschaft für Technische Zusammenarbeit/Swedish International

28 *Id.* at 13.

29 *Id.* at 14.

30 *Id.* at 14.

31 Morta Kozak, *Micro, Small and Medium Enterprises: A Collection of Published Data*, International Finance Corporation (January 2007) (Available at [http://www.ifc.org/ifcext/sme.nsf/AttachmentsByTitle/SMEDatabase.xls/\\$FILE/SMEDatabase.xls](http://www.ifc.org/ifcext/sme.nsf/AttachmentsByTitle/SMEDatabase.xls/$FILE/SMEDatabase.xls)).

32 Enhancing the Competitiveness of Micro Small and Medium Enterprises in Uganda, (Ministry of Finance, Planning and Economic Development Discussion Paper No. 15 of 2008) (Available at http://www.finance.go.ug/policy_papers.php) (Accesses 9/08/2010).

Development Agency (GTZ/SIDA) Financial Sector Deepening Project of Uganda attempted to carry out a census of microfinance institutions in 2006, but the census was neither exhaustive nor has it been updated to include recently established MFIs. The 2006 census of financial institutions in Uganda found that there were 1,207 active financial outlets, out of which 676 were savings and credit cooperatives, 104 were private companies, 73 were NGOs, 52 were development associations, 97 were microfinance deposit taking institutions, 38 were credit institutions and 168 were commercial banks.³³ Although the census provides a geographical distribution of the outlets, it has no list of the institutions, and the census numbers have not been updated. In addition, although there is an association of microfinance institutions, its register includes institutions that do not provide microfinance services and some MFIs and SACCOs have never sought membership. Therefore, it was difficult to establish the exact number of micro credit institutions in Uganda and their distribution.

For purposes of this study, I distributed questionnaires to various micro credit lenders in the different regions of the country that my research assistants and I were able to locate from directories and enquiries from people within the location. Responses from 105 financial institutions were analyzed, of which eight were from commercial banks, two from credit institutions, four from microfinance deposit institutions, 44 from microfinance institutions and 47 from savings and credit cooperatives and savings and credit societies. In terms of regional distribution, of the 105 financial institutions, 29 were from Kampala, seven from the central region (excluding Kampala), ten from the eastern region, 22 from the western region and 38 from the northern region. In addition, I held interviews with 24 financial institutions, out of which 12 institutions were the subject of in-depth case study analysis.

Below, I provide an illustration of how the number of respondents from each category compares to the entire population of the various financial institutions. It should be noted that where the number of respondents is small compared to the total number of institutions for that category, such as SACCOs and SCS, the number reported are the ones that I was able to locate. In addition, there were no significant variations in this category that would make it unreasonable to extrapolate the findings to the entire category of institutions. Although there were only seven respondents from the central region and ten from the Eastern region, the number

33 Ministry of Finance, Planning and Economic Development, Report of a Census of Financial Institutions in Uganda, 5(2006) (Available at http://www.fsdu.or.ug/pdfs/Census_of_T4_Financial_Institutions_Final_Report.pdf).

does not bias the findings. There were more financial institutions in both these regions. However, most of them were branches of those that had head offices in Kampala. In this case, the branches were analyzed together with the head office but not counted in order to avoid double counting.

Table 1: Comparison of Respondents to Estimated Population

No. of Respondents	Total No. of Institutions by Category
8 Commercial Banks	16 Commercial Banks of which 12 are foreign owned and 4 locally owned (as of 2007)
4 Credit Institutions	4 Credit Institutions (as of 2007)
4 Microfinance Deposit Taking Institutions	4 Microfinance Deposit Taking Institutions (as of 2007)
44 Non Deposit Taking Microfinance Institutions	82 (Estimate as of 2006)
47 SACCOs and SCS	628 (Estimate as of 2006)

1.6.2 Micro Enterprises

The survey covered a total of 602 micro enterprises, including 318 from Kampala (Nakasero Market, Kiseka Market, Kitintale Market, Bugolobi market, Ntinda trading center, Kamwokya market, Kalerwe market, Nakakawa market and Wandegaya) as well as micro enterprises that participated in the Uganda Women Entrepreneurs Trade Fair at Lugogo, Kampala from 13 to 15 July 2007 and the Uganda Manufacturers International Trade Fair held in Kampala from 5-11 October 2007. The eastern region survey covered 113 micro enterprises from Bugiri trading center, as well as those that participated in the Agricultural Trade Fair held at Jinja from 17 to 22 July 2007 and in the Uganda Manufacturers Association eastern region Trade Fair held at Mbale Sports ground from 31 May to 5 June 2007. The northern region survey covered 101 micro enterprises located in Gulu and Adjumani districts. The western region survey covered 70 enterprises from Mbarara town, Itendero and Kabwohe trading centers.

I also held unstructured interviews with 121 micro enterprises from various regions of the country where the surveys were conducted. The interviewees were selected from the respondents to the survey. Some were purposely selected because of the responses they had provided while others were randomly selected. Out of

the 121 micro enterprises interviewed, 52 were based in rural areas while 69 were conducting business in urban areas. In addition, seven micro enterprises were the subject of in-depth case study analysis.

1.6.3 Case Studies

In addition to the surveys and unstructured interviews, I conducted “mini” cases studies from the various categories of entities within the research population. The objective was to analyze the selected case studies in detail and demonstrate how the category of financial institutions that they belong to engenders or inhibits micro enterprises access to credit. The case studies are reported in Chapters three and four.

In the category of commercial banks, I selected Stanbic Bank and Centenary Bank. The former is the largest commercial bank in Uganda with the widest branch network and customer base, but because of its nature (foreign owned bank) and the financial services it provides, a large section of the households and small businesses cannot access credit from this bank. It is a commercial bank that serves the high-end of the credit market. Centenary Bank was selected because it is the only commercial bank in Uganda that provides microfinance. Close to 70% of the loan portfolio of this bank is micro loans.

There are four registered and licensed credit institutions in Uganda. Commercial microfinance was randomly selected from the four. However, I took a different approach with regard to the four microfinance deposit taking institutions. I selected PRIDE Microfinance and FINCA (U) Ltd. The former was selected on the basis of its size. It is the largest microfinance deposit taking institution in the country with the widest branch network and a bigger customer base than other institutions in this category. FINCA (U) Ltd is one of two microfinance deposit taking institutions that started out primarily lending to women in groups (Uganda Finance Trust is the other one). Both institutions have since diversified to include men, as well as providing credit on individual basis. However, I was not able to gain access to Uganda Finance Trust for purposes of this research while FINCA was accessible.

In the category of non-deposit taking financial institutions, I selected five micro lenders for various reasons. Masaka Microfinance Development Cooperative is a hybrid microfinance/savings and credit cooperative. Panyimur SACCO is a savings and credit cooperative that provides financial services tailored to the

economic activity of the area in which it operates. Kakuuto Savings and Credit Cooperative is a rural based micro lender, while NAGRU SACCO is an urban based micro lender. FAULU (now Opportunity Uganda and operating as a Credit Institution regulated by Bank of Uganda) was at the time of the research operating as a non-deposit taking microfinance institution. Success Microfinance and Uganda Gatsby Microfinance are lenders that were extending credit to a specific clientele that were members of a related entity, but the customers served by each institution are different.

1.7 LIMITATIONS

It was not possible to establish the number of micro credit institutions in Uganda. The estimates available are from 2006 data, which was not comprehensive and has not been updated. Therefore, I did not have a reliable source from which I could draw a typical non-probability sample for purposes of this study. I opted for a mixed methods approach to ensure that the respondents were representative of the wider population.

Micro enterprises presented a different kind of challenge. The majority are informally established so neither the companies' registry nor the local governments have data on these enterprises. The majority are also not members of any business association such as the Uganda Manufacturers Association or the Uganda National Chamber of Commerce. Some of them belong to the Association of Small Scale Industries or the Kampala City Traders Association, but none of these associations had a register of members that could readily be made available. Micro enterprises obtain annual trading licenses from the local district councils in which they operate, but none of the contacted districts had attempted to create registers or reliable data from the licenses that they had issued.

1.8 DATA ANALYSIS

The responses to the survey questionnaires were analyzed using the SPSS version 16.0 to obtain defining characteristics of the respondents such as type of business, method of establishment, persons employed, size of business, source of finance and borrowing trends. The results of the analysis are discussed in Chapter 5.

CHAPTER TWO

2.0 CREDIT, FINANCIAL DEVELOPMENT, AND ECONOMIC GROWTH: CONTEXTUALIZING THE THEORIES

This Chapter presents the relevant literature. It contains both theory and empirical work on credit markets in developing countries focusing on the following issues:

- (1) Theories in development economics and empirical evidence on the finance-growth nexus;
- (2) Literature on missing credit markets in low income countries due to factors such as weak creditor protection, lack of creditor information systems and inadequate contract enforcement mechanisms;
- (3) Credit markets in developing economies, including an analysis of the debates on enterprise demand for and need for formal credit, contractual practices of firms and the implications for the development of formal credit markets; and
- (4) The “promise of microfinance,” particularly the use of “innovative lending” methods to overcome credit market imperfections and extend credit to poor borrowers. In this context I explore the following issues:
 - (a) The structure of micro credit contracts, focusing on joint liability and its role in minimizing the problems of adverse selection and moral hazard as well as the re-assignment of roles between debtors and creditors to the party who can most efficiently perform a particular function;
 - (b) Ex-ante screening of loan applicants and the use of tools such as self-selection/assortative matching of borrowers to minimize the effects of adverse selection;
 - (c) Monitoring of borrowers, particularly the use of peer monitoring, to minimize the problem of ex-ante moral hazard;
 - (d) Enforcement of contractual obligations and the use of tools such as peer pressure, social sanctions, joint liability, and the incentive of contingent credit to ensure compliance with contractual obligations; and
 - (e) The determinants of repayment rates. Here I explore the theories and empirical findings on the impact of various factors on loan repayment rates. These include the effect of wealth, social homogeneity, group size, loan size and loan duration on loan repayment. I also compare the performance of individual and group loans.

2.1 FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH: IS THERE A NEXUS?

Economists stress the importance of credit for economic growth.³⁴ Lack of access to credit has been identified as one of the factors that not only engenders poverty and income inequality,³⁵ but that also inhibits economic growth and development.³⁶ Various development economists have long mapped out the finance-growth nexus, and substantial empirical evidence supports this trajectory.³⁷ Increased financial intermediation not only leads to growth in terms of per capita GDP, but also reduces income inequality and enhances social development (such as lower infant mortality rates, increased school enrollment and reduced child labor).³⁸ However, for financial development to impact economic growth, sound credit rights systems that give confidence to lenders to grant credit must be in place.³⁹ Therefore, in many developing economies, credit is constrained due to among other factors, lack of adequate creditor protection.

The preconditions for a sound credit market include: access to information about debtors, predictable creditor enforcement mechanisms, and clear creditor priority and security realization systems. Development economists generally

³⁴ I am aware that the preconditions for economic development are much broader than the single issue of access to credit. The World Bank lists six governance indicators for economic development: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption. Daniel Kauffman *et al.*, Governance Matters IV: Governance Indicators for 1996–2004 (World Bank Policy Research Working Paper No.3630, 2005) (Available at <http://go.worldbank.org/LMEFJR710>). However, for purposes of this thesis, I focus on rule of law issues that affect the efficient performance of credit markets.

³⁵ Asli Demirguc-Kunt & Ross Levine, *Finance and Economic Opportunity* (World Bank Policy Research Working Paper No. 4468, 2008) (Available at <http://go.worldbank.org/184RL2DCK0>) (Arguing that not only does financial development accelerate economic growth which helps the poor, but that it exerts a disproportionately positive influence on the poor. In addition, that financial market imperfections limit economic opportunities for the poor to the extent that they constrain the degree to which economic opportunities are defined by talent and initiative or by parental wealth and social connections).

³⁶ Heywood W. Flessig, *Secured Transactions: The Power of Collateral*, 33 Finance and Development 44 (1996).

³⁷ The finance-growth nexus generated considerable debate among development economists. Some economists such as King, Levine, Rajan and Zingales attempted to empirically demonstrate the causal relationship between financial development and economic growth, while on the other hand, other economists like Arestis and Demetriades argued some endogenous factors besides financial development lead to economic growth, or alternatively that financial development is, at best, a facilitator of economic development. This debate has now been settled as seen in the foregoing discussion.

³⁸ Thorsten Beck, Asli Demirguc-Kunt & Ross Levine, *Finance, Inequality and the Poor*, 12 Journal of Economic Growth 27(2007).

³⁹ The World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, para 8 (April 2001) (<http://vlex.com/vid/principles-guidelines-insolvency-creditor-462640>).

agree that these preconditions are essential for the development of efficient credit markets, and therefore the World Bank and the IMF have initiated reform programs in several developing and emerging economies that embody those principles.⁴⁰ The reforms have largely focused on legal reform, institutional and capacity building programs for courts, land registries, and streamlining property ownership. Their objective is to create predictable and reliable creditor protection mechanisms that give creditors incentives to grant credit and therefore stimulate economic growth.

Another constraint that developing economies face is that the majority of economic players--micro, small and medium enterprises (MSMEs), are rationed out of the credit market. The lack of access to credit negatively impacts their growth and economic potential. Cross country studies have shown that financial intermediation reduces income inequality by disproportionately boosting the incomes of the poor, thereby reducing poverty.⁴¹ Therefore, to broaden access to credit, the World Bank and IMF reform programs also entail micro credit development as a strategy to improve access to credit for poor households and small businesses. As evidenced in the graph below, although firms in all regions of the world face financing constraints, the magnitude of the problem in Sub-Saharan Africa is most severe.

40 Since the early 1990's, The World Bank has been involved in financial development initiatives such as reforming bankruptcy and collateral laws in various developing countries. See The World Bank, *supra* note 39.

41 Beck, Demirgüç-Kunt & Levine, *supra*, note 38. The authors state that the results of a study involving 52 developed and developing countries from 1960 to 2005 showed a positive correlation between financial intermediary development and income distribution, and that in particular, financial development boosts income of the poorest and reduces income inequality.

Figure 1: Percentage of Firms Reporting Finance as a Problem



Source: Asli Demirguc-kunt *et al.*, Finance for All? Policies and Pitfalls in Expanding Access 6 (2008).

The reform programs recognize that unlike industrialized economies that have well-functioning equity and debt markets, most developing countries rely on debt, in particular, bank credit. Therefore, creditor confidence is critical. Creditors will not extend credit if they are uncertain about recovery and enforcement of contracts and debtors can get away without honoring their contractual obligations.⁴²

Initial development economics theories evolved within the context of macro-economic analysis. Therefore, issues such as economic growth were analyzed within the broader context of economic factors such as capital accumulation through savings, education, taxation, and impact of economic policies on sustainable production and growth. Micro-economic analysis is a much later phenomenon that is used to study specific causal relationships such as the correlation between finance

42 Kenneth W. Dam, *Credit Markets, Creditor's Rights and Economic Development*, (University of Chicago Law School, John M. Olin Law and Economics Working Paper No. 281, 2006) (http://www.ssrn.com/abstract_id=885198).

and growth. Joseph Schumpeter was one of the earlier economists to map out the finance-growth trajectory. He not only pointed out that financial intermediation facilitates industrial development because credit enables entrepreneurs to assemble factors of production,⁴³ but also that financial intermediation allows for efficient allocation of resources through creative destruction.⁴⁴ Schumpeter's finance-growth nexus generated substantial debate among economists.⁴⁵

To test Schumpeter's theory, Robert King and Ross Levine⁴⁶ used data from 80 countries from 1960 to 1989 to establish whether a correlation existed between the level of financial development and economic growth, capital accumulation and economic efficiency. They used four indicators to measure financial development: the ratio of liquid liabilities to GDP, financial institutions providing intermediation (such as banks), private credit as a percentage of total credit, and private credit as a percentage of GDP. Per capita GDP growth, rate of capital accumulation, and improvements in economic efficiency were used as growth indicators. King and Levine found that controlling for individual country and policy characteristics, higher levels of financial development were positively associated with higher rates of faster economic growth, physical capital accumulation, and economic efficiency improvements. In addition, financial development was significantly correlated with long-run economic growth.

In a later study, Panicos Demetriades and Khaled Hussein⁴⁷ used time-series data from 16 developing countries from 1960 to 1990 to investigate the causal link between financial development and economic growth. Unlike the King and Levine study, which they heavily criticized,⁴⁸ the authors found that the causal

43 Joseph A. Schumpeter, *supra* note 5, at 102.

44 Raghuram G. Rajan and Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 61 *Journal of Financial Economics* 5 (2003).

45 See Raymond W. Goldsmith, *Financial Structure and Development*, (1969); Robert E. Lucas Junior, "On the Mechanics of Economic Development" 22 *Journal of Monetary Economics* 3 (1988); Ronald I. McKinnon, *Money and Capital in Economic Development* (1973); Robert G. King and Ross Levine, *Financial Intermediation and Economic Development*, in *Capital Markets and Financial Intermediation* (Colin Meyer & Xavier Vives eds., 1993); Robert G. King and Ross Levine, *Financial Indicators and Growth in a Cross-Section of Countries*, (World Bank Policy Research Working Paper No. 819, 1992); Robert G. King & Ross Levine, *Finance, Entrepreneurship and Growth: Theory and Evidence*, 33 *Journal of Monetary Economics* 513 (1993).

46 Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might be Right*, 108 *Quarterly Journal of Economics* 717 (1993).

47 Panicos O. Demetriades & Khaled A. Hussein, *Does Financial Development Cause Economic Growth? Time Series Evidence from 16 Countries* 51 *Journal of Development Economics* 387 (1996).

48 *Id.* at 390-91 (arguing that the King and Levine's indicators, at best, show a contemporaneous relationship between finance and growth. In addition, the cross-section analysis method that they used could not allow different countries to exhibit different patterns of causality).

relation between financial development and economic growth was, at best, country specific. Their findings showed that financial indicators caused economic growth in only three countries, a reverse causation in six countries, and a bi-directional relationship in seven countries (financial development influences economic growth which in turn facilitates financial development).⁴⁹ Other studies have also been critical of King and Levine. Arestis and Demetriades⁵⁰ argue that country specific factors, such as differences in financial institutional structures, financial policies, and government effectiveness, may create variations in the causal nature of the relationship between financial development and economic growth.

Some recent studies suggest that financial intermediaries exert a large positive impact on productivity and GDP growth.⁵¹ On the other hand, some studies have suggested that although the causal nature of the finance-growth nexus is less clear, it is possible to conclude from the various empirical studies that, with a few exceptions, a positive long-run association exists between financial development and economic growth.⁵²

The finance-growth debate has now largely been settled, and there is substantial empirical evidence of the finance-growth nexus. For example, in most economies, SMEs are considered the engine of economic growth because of their contribution to private sector economic activity and employment creation. However, in circumstances where credit is constrained, small firms, including SMEs, face higher financing obstacles than larger and more established firms.⁵³ Such credit constraints are attributed to, among other factors, weaknesses in the financial systems of many developing countries.⁵⁴ Thorsten Beck proposes various strategies to improve SME access to finance. These strategies include reforms in information and contractual frameworks and macroeconomic performance, competitiveness in the

49 A study by Mohammed Trabelsi also revealed mixed findings. See Trabelsi, Mohammed, *Finance and Growth: Empirical Evidence from Developing Countries, 1960-1990*, 13 Cahier de recherche 1 (2002).

50 Philip Arestis & Panicos Demetriades, *Finance and Growth: Institutional Considerations, Financial Policies and Causality*, 2 Zagreb Economic Papers 37 (1997).

51 Thorsten Beck, Ross Levine & Norman Loayza, *Finance and the Sources of Growth*, 58 Journal of Financial Economics 261 (2000).

52 Panicos Demetriades & S. Andrianova, *Finance and Growth: What we Know and What we Need to Know* in C.A.E Goodhart ed., *Financial Development and Growth: Explaining the Links*, 38, 48 (2004).

53 Meghana Ayyagari, Asli Demirgüç-Kunt & Vojislav Maksimovic, *How Important Are Financing Constraints? The Role of Finance in the Business Environment*, (World Bank Policy Research Working Paper 3820, 2006) (Available at <http://go.worldbank.org/J8ZFYH8GR0>)

54 Thorsten Beck, *Financing Constraints of SMEs in Developing Countries: Evidence, Determinants and Solutions 1* (2007). (Available at <http://center.uvt.nl/staff/beck/publications/obstacles/financingconstraints.pdf>) (Accessed 1/6/2009).

financial system, and a regulatory framework that enables financial institutions to develop products for SMEs such as leasing and factoring.⁵⁵ Studies have also shown that financial development boosts economic growth by disproportionately fostering small firm growth because it lowers transaction costs and informational barriers that hinder their growth.⁵⁶

2.2 MISSING CREDIT MARKETS IN LOW INCOME COUNTRIES AND THE IMPLICATIONS FOR THE FINANCE-GROWTH TRAJECTORY

As discussed in section 2.1 above, access to credit is critical for financial development and economic growth. Some studies have revealed that while most people in the developed world take access to banking services and credit for granted, the majority of individuals and businesses, particularly MSMEs face credit constraints for a variety of reasons.⁵⁷ The factors that affect access to credit include price and non-price related costs, such as difficulty accessing loan application centers, non-affordability (high minimum balances and fees), and onerous eligibility requirements.⁵⁸ Higher costs are associated with higher firm financing obstacles,⁵⁹ and generally costs are negatively correlated with financial development and economic growth.⁶⁰ Poor physical infrastructure, lack of contractual and informational frameworks, restrictive bank regulatory and supervisory frameworks, market structure, and bank characteristics such as size, ownership and business orientation, and banks' rational business decisions, are some of the factors attributed to the high costs of accessing credit.⁶¹

As earlier mentioned, firms may be financed using either formal or informal credit and that the latter can play an important role, particularly in the absence of formal credit. For example, informal networks of businesses, such as the Asian communities in East Africa are known to have mitigated the problems of information asymmetry and weak contract enforcement, thereby providing a mechanism for informal access to credit amongst their members.⁶² However, evidence suggests that for firms that need external financing, there is a positive correlation between access to formal credit and firm growth, innovation and ultimately economic growth. Access to

55 *Id.* at 14–23.

56 Thorsten Beck, Asli Demirguc-Kunt, Luc Laeven & Ross Levine, *Finance, Firm Size and Growth*, 40 *Journal of Money, Credit and Banking* 1371 (2008).

57 Thorsten Beck, Asli Demirguc-Kunt & Maria Soledada Martinez Peria, *Reaching Out: Access to and Use of Banking Services Across Countries*, 85 *Journal of Financial Economics* 234–66 (2007).

58 *Id.* at 246–7.

59 *Id.* at 251.

60 *Id.* at 250.

61 *Id.* at 255–61.

62 Tyler Biggs & Shah Manju, *African SMEs, Networks and Manufacturing Performance*, 30 *Journal of Banking and Finance* 3043 (2006).

formal credit has been found to increase returns to capital,⁶³ as well as promote entrepreneurship and increase the survival rates for new entrepreneurs.⁶⁴ In addition, although the majority of firms that are credit constrained rely on informal sources of credit, studies have shown that formal credit is associated with faster firm growth.⁶⁵ A study of private sector firms in China revealed that although most firms financed their businesses using informal credit because access to formal credit was severely constrained by factors such as bank corruption, lack of collateral and government interference, financing from formal sources was associated with faster firm growth than fundraising from informal sources.⁶⁶ A randomized field experiment in Mexico, in which small retail firms were given cash and capital stock, showed an increase of 20–100% in the profits of firms that faced the most severe financial constraints.⁶⁷ The firms were selected randomly to minimize the effects of firm specific factors, including entrepreneurial ability and market forces, such as demand for a particular firm's product.

As noted earlier, credit constraints are particularly severe for small firms,⁶⁸ which translates into slower growth.⁶⁹ Size, age, and ownership have been found to be significant predictors of financing obstacles because evidence shows that smaller, younger, and local firms are more likely to face higher financing constraints than their larger, older, and foreign-owned counterparts.⁷⁰ In addition, for sectors that are dependent on external financing, credit constraints hinder firm entry and post-entry growth, especially for small firms.⁷¹ Therefore, improvements in the rule of law, particularly property rights protection, shareholder holder protection, creditor rights protection and contract enforcement, increase external financing opportunities for all firms, and significantly more for smaller firms.⁷²

63 Robert J. Cull, David McKenzie & Christopher Woodruff, *Experimental Evidence on Returns to Capital and Access to Finance in Mexico*, 22 World Bank Economic Review 457 (2008).

64 Asli Demirgüç-Kunt, Leora F. Klapper & Georgios A. Panos, *The Origins of Self-Employment* (February 2007) (Paper Presented at the Conference on Access to Finance, March 15–16, The World Bank, Washington: DC) (Available at <http://siteresources.worldbank.org/INTFR/Resources/BosniaFeb07Klapperetal.pdf>).

65 Meghana Ayyagari, Asli Demirgüç-Kunt & Vojislav Maksimovic, *Formal Versus Informal Finance: Evidence from China*, World Bank Policy Research Working No. 4465 (2008).

66 *Id.* at 26, 39–40

67 Cull *et al.*, *supra*, note 63, at 18.

68 Thorsten Beck & Asli Demirgüç-Kunt, *Small and Medium Size Enterprises: Access to Finance as a Growth Constraint*, 30 Journal of Finance and Banking 2931 (2006).

69 Thorsten Beck, Asli Demirgüç-Kunt & Vojislav Maksimovic, *Financial and Legal Constraints to Firm Growth: Does Firm Size Matter?* 60 Journal of Finance 137 (2005).

70 Thorsten Beck, Asli Demirgüç-Kunt, Luc Leaven & Vojislav Maksimovic, *The Determinants of Financing Obstacles*, 25 Journal of International Money and Finance 932 (2006).

71 Philippe Aghion, Thibault Fally & Stefano Scarpetta, *Credit Constraints as a Barrier to Entry and Post-Entry Growth of Firms*, 22 Economic Policy 731 (2007).

72 Thorsten Beck, Thorsten, Asli Demirgüç-Kunt, & Vojislav Maksimovic, *Financing Patterns Around the World: Are Small Firms Different?*, 89 Journal of Financial Economics 467 (2008).

Although access to credit is a critical component of the finance-growth trajectory, some preconditions are necessary to develop an efficient credit market. These include creditor protection, contract enforcement, and accounting.⁷³ The section below discusses the importance of contract enforcement for access to credit as well as for financial development and economic growth.

2.2.1 The Preconditions for Efficient Credit Markets: Creditor Protection

In a paper on creditor rights and economic development, Kenneth Dam states that most economists believe that the best system of economic development is one that gives the strongest protection for creditors because the protection maximizes their willingness to lend.⁷⁴ Empirical research has shown that variations in creditor rights protection are associated with variations in the availability of external financing.⁷⁵ Arturo Galindo and Alejandro Micco also argue that strong institutions for the protection of creditor rights not only foster the development of credit markets, but also reduce the volatility of credit during periods of economic shocks such as recessions.⁷⁶

The notion that a strong creditor rights system boosts creditor confidence has influenced many credit market development initiatives, particularly those supported by the IMF and the World Bank.⁷⁷ Legal and institutional reform processes usually focus on minimizing information asymmetries for lenders, enabling lenders to register security interests in property pledged as collateral,⁷⁸ strengthening courts and other tribunals that enforce contracts, and reforming bankruptcy laws to assure a proper system of priority in cases of multiple creditors.

However, some people have been critical of creditor rights systems and question their efficiency. Jorge Padilla and Alejandro Roquejo⁷⁹ argue that although some studies have shown a positive correlation between the degree of creditor protection

73 Ross Levine, Norman Loayza & Thorsten Beck, *Financial Intermediation and Growth: Causality and Causes*, 46 *Journal of Monetary Economics* 31 (2000).

74 Kenneth W. Dam, *supra* note 42.

75 Raphael La Porta *et al.*, *Legal Determinants of External Finance*, 52 *Journal of Finance* 1131 (1997).

76 Arturo Galindo & Alejandro Micco, *Creditor Protection and Credit Volatility*, (Inter America Development Bank: Latin America Research Network Working Paper No. 528, 2008) (Available at <http://www.iadb.org/res/publications/pubfiles/pubWP-528.pdf>)

77 The World Bank, *supra* note 39.

78 Heywood Flessig, Meynaz Safavian & Nuria De La Pena, *Reforming Collateral Laws to Expand Access to Finance* 13–20 (2006)

79 Atilano Jorge Padilla & Alejandro Roquejo, *The Costs and Benefits of the Strict Protection of Creditor Rights: Theory and Evidence*, (Inter- America Development Bank Research Network Working Paper No.R–384, 2000).

and lending volume, as well as use of external financing, no conclusive evidence shows that a strong creditor rights system leads to market efficiency. They argue that as prior findings have shown, the quality of judicial enforcement is critical for credit market development, but not necessarily for the enhancement of creditor rights.⁸⁰ In addition, some commentators have argued that while strict creditor protection may make credit cheaper, it may also cause some inefficiencies if overly protected creditors neglect to screen projects. Therefore, some level of debtor protection is necessary to ensure an efficient credit market.⁸¹

In the context of micro credit, it is understood that although credit boosts growth and alleviates poverty, small and micro enterprises lack access to credit because they operate largely in informal settings, have a low survival rate, and operate with small amounts capital, all of which translates into increased risk for the main stream credit providers, such as commercial banks. Efforts to improve access to credit for such sectors have focused on “innovative” lending strategies, such as group lending, that minimize risk for creditors.⁸² Although the strategies are designed to increase access to credit for those that would otherwise have difficulty obtaining credit, they embody the principles of creditor rights systems. However, some scholars argue that creditor and debtor protection should be balanced because small creditors are prone to abusive lending, which in turn impacts both access to credit and poverty reduction.⁸³

This literature illustrates that inadequate creditor protection increases the cost of credit for both lenders and borrowers. For the lenders, the costs are the risks associated with adverse selection and moral hazard; for borrowers, it is reduced credit supply and increased cost of credit. The costs faced by borrowers affect all firms. However, it is the smaller ones that are hurt most⁸⁴ because larger firms may be in a position to overcome some hurdles of accessing credit through network effects and reputation. Therefore, since MSMEs are major economic players in most developing countries, it is important to address the factors that make it difficult for them to access credit.

⁸⁰ *Id.* at 32.

⁸¹ Michael Manove, Jorge A. Padilla & Marco Pagano, *Collateral versus Project Screening: A Model of Lazy Banks*, 32 RAND Journal of Economics 726 (2001).

⁸² Jameel Jaffer, *Microfinance and the Mechanics of Solidarity Lending: Improving Access to Credit Through Innovations in Contract Structure*, 9 Journal of Transnational Law and Policy 183 (1999).

⁸³ Kozolchik, Boris, *Secured Lending and Its Poverty Reduction Effect*, Arizona Legal Studies Discussion Paper No.06-33, 2006 (available at <http://ssrn.com/abstract=929397>).

⁸⁴ Thorsten Beck *et al.*, *supra*, note 69. The authors found that it is the smallest firms that are most adversely affected by financial and legal constraints as well as corruption. See also Thorsten Beck *et al.*, *supra*, note 56; Galindo & Micco, *supra*, note 76

2.2.2 The Importance of Functional and Efficient Contract Enforcement Institutions

Enforcement institutions may be formal or informal. Formal institutions are the legal rules and courts of law or tribunals that enforce the legal rules. Informal institutions include trust and reputation, network or kinship ties and social capital. In this section, I discuss both institutions in relation to the functioning of credit markets.

A vast body of literature in law and economics, analyzes the effect of variations in legal enforcement on financing patterns around the world. Some forms of finance such as equity are more commonly used in some jurisdictions such as the U.S and the U.K while others typically use debt. Firm ownership structures also differ. Some jurisdictions have dispersed share ownership structures, while others are characterized by concentrated ownership structures. Some commentators have attributed these variations to differences in the degree of protection accorded to outside providers of capital.⁸⁵

Empirical studies in law and economics attempt to explain the factors responsible for the variations in legal enforcement, and ultimately, in creditor protection, as well as to account for differences in finance and ownership patterns. Some studies have pointed to historical factors, such as legal origin, and the impact of peculiarities of a legal system on financial development. The argument is that legal systems differ in the protections they accord and since private property rights protection is crucial for financial development, historical differences in legal origin account for variations in finance and ownership structures. The legal origins theory is controversial and has generated substantial debate in the field of law and economics.

In their seminal works, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (hereinafter LLSV) found empirical evidence that common law systems are superior to civil law systems regarding of shareholder and investor protection. This finding arose from a study of laws pertaining to investor protection across 49 countries in Europe, North and South America, Africa, Asia, and Australia to establish why finance and firm ownership structures differ. The authors assessed the ability of firms in 49 countries with different legal systems, to raise external finance, either through debt or equity, and found strong evidence that the legal environment (the quality of legal investor protections and the quality of their enforcement) had an impact on the size and breadth of capital markets.⁸⁶ LLSV attributed this result to the availability of legal protection to external providers of finance, against expropriation, which raised their willingness to lend.

85 Raphael La Porta *et al.*, *Legal Determinants of External Finance*, 52 *Journal of Finance* 1131 (1997).

86 Raphael La Porta *et al.*, *supra*, note 85.

They further stated that, controlling for per capita income, their results showed that French civil law countries had the weakest investor protections when compared to common law countries.⁸⁷ In a subsequent paper, LLSV argued that laws and the quality of their enforcement determine how firms are financed and owned.⁸⁸ In addition, the authors built on the legal origins theory to show that independent of per capita income, civil law jurisdictions give investors weaker legal rights than common law jurisdictions, which in turn explains the variations in firm finance and ownership structures.⁸⁹

Although the LLSV studies were, to some degree, accurate regarding the attributes of particular legal systems, as well as of firm financing and ownership patterns, they did not take into account the fact that legal systems gradually evolve to adapt to new circumstances. In addition, although LLSV hailed the common law system as more adaptive than the civil law system, and, therefore, better suited to foster financial development, they ignored the fact that legal systems vary depending on endogenous factors such as culture and the efficiency of institutions. Jappelli, Pagano and Biaco have pointed out that even countries with similar legal rules may enforce them differently depending on the efficiency and honesty of their judiciary.⁹⁰ LLSV also did not take into account the impact of increased intra-legal interaction and the gradual convergence of legal systems. For example, a study of venture capital contracts in a set of high income European countries found that most of the contractual variations between civil and common law countries in their sample was explained by the fact that private equity groups use contracts that are similar to the ones they employ in their home countries irrespective of the legal system in which they operate.⁹¹

Weaknesses in some common law countries, especially in developing economies, as well as strong civil law countries such as Sweden,⁹² also present exceptions to the legal origins theory. Some scholars who have been critical of the legal origins theory include Mark Roe⁹³ and Gillian Hadfield.⁹⁴ The LLSV papers have attracted

87 *Id.* at 1132.

88 Raphael La Porta *et al.*, *Law and Finance*, 106 *Journal of Political Economy* 1113 (1998).

89 *Id.* at 1151-2.

90 Tullio Jappelli, Marco Pagano & Magda Bianco, *Courts and Banks: Effects of Judicial Enforcement on Credit Markets*, 37 *Journal of Money, Credit and Banking* 223, 224 (2005).

91 Steven N. Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 *Review of Economic Studies* 281 (2003).

92 Commenting on variations in share ownership structures, Gilson states that some countries such as Sweden have concentrated ownerships but have strong shareholder protection laws and therefore cannot be placed in the same category as those jurisdictions with weak shareholder protection rules and therefore, typically have controlling shareholders. Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 *Harvard Law Review* 1641 (2006).

93 Mark J. Roe, *Legal Origins and Modern Stock Markets* 120 *Harvard Law Review* 460 (2006).

94 Hadfield Gillian K. (2007) *The Quality of Law in Civil Code and Common Law Regimes: Legal Human*

substantial criticism, particularly with regard to their methodology, the nature of their findings,⁹⁵ and the oversimplification and generalizations about civil and common law legal systems.⁹⁶ However, their studies are important in as far as they demonstrate the importance of rule of law, in particular legal rules and their enforcement to support economic transactions. Kenneth Dam states that in the many economic articles, by LLSV and others, there is a broad recognition that the enforcement of contracts and the protection of property are vital to financial development.⁹⁷

In a more recent study, Simeon Djankov, Carlee Macleish and Andrei Shleifer attempt to substantiate the LLSV legal origins hypothesis. In a 25 year (1978–2003) study of credit markets in 129 countries, they found that although legal origin is not on its own a significant factor, there was evidence that countries with common law origins have better legal protections for creditors, while civil law countries compensate for weaknesses in legal protections by having stronger credit information systems.⁹⁸ The authors also found patterns of increased private credit to GDP ratios with improvements in creditor rights or with the introduction of credit registries.⁹⁹ In addition, they were able to determine that, contrary to notions about convergence of legal systems, there was clear evidence from 1978 to 2003 that creditor rights protection varies systematically across legal systems, thus indicating no trend of convergence in creditor rights protection.¹⁰⁰

In a study of debt enforcement in 88 countries, Simoene Djankov *et al.*,¹⁰¹ found variations in the efficiency of debt enforcement procedures, with richer countries being more efficient than poorer countries, in addition to having a comparative advantage in more complex procedures such as reorganizations. They suggested that in light of these variations, different debt enforcement institutions

Capital and the Evolution of Law, (University of Southern California CLEO Research Paper No. CO7-3(2007) (Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=967494).

95 Padilla and Requejo, *supra*, note 79, at 6 (built on the work of LLSV to study the impact of legal enforcement on debt volume, interest rates and default rates. They concluded that effective judicial system is crucial for the development and optimal performance of credit markets. However, they found no conclusive evidence of the effect of credit rights protection on credit market efficiency).

96 See Kenneth W. Dam, *supra* note 42; Gillian K. Hadfield, *supra*, note 94.

97 Kenneth W. Dam, *The Law- Growth Nexus: The Rule of Law and Economic Development*, 35 (2006).

98 Simeon Djankov, Caralee McLiesh & Andrei Shleifer, *Private Credit in 129 Countries*, 84 *Journal of Financial Economics* 299 (2007).

99 *Id.* at 301.

100 *Id.* at 308–12.

101 Simeon Djankov, Oliver Hart, Caralee Macleish & Andrei Shleifer, *Debt Enforcement Around the World*, 116(6) *Journal of Political Economy* 1105 (2008).

might be appropriate at different levels of income.

To illustrate the importance of legal enforcement to the efficient performance of credit markets, consider a simple lending transaction in which a creditor lends money to a borrower on the understanding that she will pay back the principal sum and interest. If the borrower defaults, the creditor has four options: sue the borrower, deny her future credit, damage her reputation,¹⁰² or use illegitimate force. The decision to sue will depend on whether the creditor can rely on the legal system to force the debtor to pay and the cost of litigation. Denying the debtor in default future credit or damaging her reputation can only be an effective threat if the debtor needs future credit and if the market is able to pick up the information about the defaulting debtor (information asymmetry). The creditor may opt for illegitimate coercion if he has the means and capacity to do so.

Now consider a lending transaction in which the creditor requires collateral as security for the loan. The ability of the borrower to obtain credit will depend on whether she has title to property (such as a land title) in which she can grant a security interest to the lender and on the creditors' perceptions about his ability to attach and sell the collateral in the event of default. Therefore, property rights and their enforcement are critical.¹⁰³ If the borrower owes money to several creditors, some secured and others unsecured, the ability of the creditors to recover the debt in the event of default will depend on a country's bankruptcy laws that assign priority to the creditors and protect the borrowers' assets from wasteful dissipation by the creditors. Enforcement institutions are critical for both single debtor-creditor transactions and for transactions involving multiple creditors. The extent to which creditors will be willing to grant credit will depend on the nature and efficiency of protections available to them. In a single debtor-creditor transaction, the role of the courts is to enforce repayment and upon default, facilitate the transfer of ownership and control from the debtor to the creditor.¹⁰⁴ In transactions involving one debtor and multiple creditors, the legal system must provide an orderly mechanism to distribute the borrower's assets among the creditors.¹⁰⁵

102 Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 29 *American Society Review* 55 (1963); W. Bentley Macleod, *Reputations, Relationships and Contract Enforcement*, 45 *Journal of Economic Literature* 595 (2007); Janvier D. Nkurunziza, *Reputation and Credit without Collateral in Africa's Formal Banking* (*The Centre for the Study of African Economies Working Paper Series*, Working Paper 236, 2005) (Available at <http://www.bepress.com/csae/paper236>).

103 Richard A. Posner, *Economic Analysis of Law* 33 (2007) (arguing that the creation of individual, as distinct from collective ownership rights, is a necessary rather than sufficient condition for the efficient use of resources).

104 Oliver Hart, *Firms, Contracts, and Financial Structure*, 95-125 (1995).

105 *Id.* at 156-85.

Commenting on the importance of enforcement institutions, Padialla and Roquejo state that:

A credit relationship involves three parties: a lender... a borrower... and the courts of law that enforce the loan contract in case of a dispute... For instance no lender would ever consider funding a borrower unless there is a third party (usually, the courts of justice). In the absence of such third party, the borrower would simply refuse to pay, and the lender would have no option but to afford the losses. It is true that loan contracts often include collateral requirements whose main aim is to protect lenders against the consequences of default by the borrower. But again, these collateral requirements are only effective if there is a third party who stands ready to protect and enforce the creditor's right to foreclose... in the event of default... Therefore, the existence of a third party who performs this enforcement role is instrumental for the development of the credit market. The greater the efficiency and predictability of the third party's actions and proceedings, the easier it is for lenders and borrowers to realize their potential gains from trade. Consequently we should expect to find widespread use of external finance, and in particular, debt, in countries with more efficient judicial systems...¹⁰⁶

Jappelli, Pegano and Bianco¹⁰⁷ also state that laws and their enforcement by the judiciary help determine the ex-ante willingness of creditors to extend loans, thereby increasing the volume of lending and opening up the credit markets to otherwise un-creditworthy borrowers. The authors use a model of risk neutral banks, facing a continuum of borrowers, to illustrate how judicial inefficiency affects credit market performance. Their results show that poor judicial enforcement increases borrowers' opportunistic behavior, and constrains and increases the cost of credit. Therefore, the key function of the courts is to force solvent borrowers to honor their commitments.

In the absence of reliable, efficient, legal enforcement institutions, creditors will either be forced to withhold credit or adopt alternative risk mitigating mechanisms, such as charging high interest rates or granting credit only to borrowers who have a good reputation or with whom they have close social and kinship ties.¹⁰⁸ All these mitigating measures affect access to credit. Granting credit on the basis of

¹⁰⁶ Atilano Jorge Padilla & Alejandro Roquejo, *supra*, note 79.

¹⁰⁷ Tullio Jappelli, Marco Pegano & Magda Bianco, *supra*, note 90.

¹⁰⁸ Marcel Fafchamps, *Ethnicity and Credit in African Manufacturing*, 61 *Journal of Development Economics* 205(2000). For a detailed discussion on the role and limits of kinship ties in contract enforcement see Janet T. Landa, *A Theory of the Ethnically Homogenous Middleman Group: An Institutional Alternative to Contract Law* 10 *Journal of Legal Studies* 349(1981); Robert C. Elickson, *Order Without Law: How Neighbors Settle Disputes*, 1991 (discussing the role of informal norms in dispute settlement closely knit societies).

reputation and social or kinship ties may enable some people to access credit, but, to the extent that it diminishes impartial exchange, it increases costs for those who are unable to access credit in that manner. Using interest rates as a risk mitigating tool also has adverse consequences. While an ordinary lending transaction involves payment of interest to compensate for the time value of money and risk involved,¹⁰⁹ adverse selection problems may result from using interest premia as a risk offsetting mechanism. In this respect, Stiglitz and Weiss warn that using of interest rates as a screening device can increase risks for the bank because of the decrease in the quality of borrowers as interest rates rise.¹¹⁰

There is substantial empirical evidence on the use of informal enforcement mechanisms. Avner Greif argues that although neoclassical economists place the legal system at the center of contract enforcement, empirical evidence suggests otherwise. Informal enforcement mechanisms such as morality, personal trust, and reputation have facilitated anonymous exchange.¹¹¹ In addition, he states that efficient, impartial, contract enforcement institutions are only a recent development and that evidence shows that reputation was used as an enforcement mechanism by medieval merchants in Europe.¹¹² In Africa, it has also been suggested that banks compensate for deficiencies in formal legal enforcement by relying on reputation built through repeated transactions with creditors.¹¹³

Avner Greif also argues that policies aimed at enhancing contract enforcement must be country and time-specific taking into account the cultural, political and social environment in which the enforcement system is an integral part.¹¹⁴ However, some economists suggest the contrary. As discussed in section 2.2.1, evidence shows that countries where legal enforcement is more efficient have better developed credit and financial markets. In addition, informal enforcement mechanisms such as

109 Marcel Fafchamps *et al*, *Enterprise Finance in Kenya*, Regional Program on Enterprise Development, The World Bank (1994), (Available at <http://www.econ.ox.ac.uk/members/marcel.fafchamps/homepage/kenya.pdf>) (the authors state at p. 13, that in Africa, interest rate premia are very high because in addition to the usual concerns of creditors, banks in Africa suffer from political interference, poor infrastructure, high taxes and high inflation).

110 Joseph E. Stiglitz & Andrew M. Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 *American Economic Review* 393, 396 (1981).

111 Avner Greif, *Contracting, Enforcement and Efficiency: Beyond the Law*, 239, in *Annual World Bank Conference on Development Economics* (Michael Bruno & Boris Pleskovic ed., 1997).

112 Avner Greif, *The Empirical and Theoretical Underpinnings of the Law Merchant: Impersonal Exchange without Impartial Law: The Community Responsibility System*, 5 *Chicago Journal of International Law* 109 (2004).

113 Janvier D. Nkurunziza, *Reputation and Credit without Collateral in Africa's Formal Banking* (Center for the Study of African Economies Working Paper No. 2005-02) (Available at <http://www.bepress.com/csae/paper236/>)

114 Avner Greif, *supra* note 111, at 33.

reputation, make it difficult for new market entrants to obtain credit, and enforcement through kinship ties ceases to be efficient as interactions expand and transactions become more complex.¹¹⁵

We can conclude from this literature that enforcement institutions serve at least three functions: (1) aligning the interests of debtors and creditors, (2) boosting creditor confidence to provide more credit, and (3) ensuring efficient transfer of property from debtors to creditors in the event of default (repossession and bankruptcy). While contracts may be enforced either formally or informally, the latter is much more significant and relevant in the absence of the former, as well as more appropriate within the context of low volume, relational, and repeat contractual relationships. This has led some theorists to suggest that at low levels of economic development, informal enforcement mechanisms may substitute for formal contract enforcement.¹¹⁶ However, as transactions become more complex and as economies grow, informal enforcement becomes inefficient, and it is necessary to develop institutions that ensure third-party enforcement.¹¹⁷

2.3 CREDIT MARKETS IN LOW INCOME COUNTRIES

Empirical work and policy discussions on financial markets in developing and emerging economies acknowledge that a sound financial system can spur economic growth by improving the average productivity of capital, channeling investment funds to firms and mobilizing savings.¹¹⁸ It is also clear that in most developing economies, difficulties in contract enforcement affect access to credit¹¹⁹ and increase the cost of borrowing, which in turn hinders financial system development and overall economic growth because individuals and businesses experience difficulties contracting around this risk. Considerable work has been done on credit markets in Africa covering a broad range of issues including demand for and access to credit, cost of credit, contracting practices of firms. In sections 2.3.1 and 2.3.2, I present literature on enterprise finance and contracting practices of firms in Africa.

115 Douglass C. North, *Institutions, Institutional Change and Economic Performance* 55 (1990).

116 Michael Trebilcock & Jing Leng, *The Role of Formal Contract Law and Enforcement in Economic Development*, 92 *Virginia Law Review* 1517, 1519 (2006).

117 Douglass C. North, *supra*, note 115, at 57.

118 Panicos Demetriades, *Financial Markets and Economic Development*, 9-29 in *FINANCIAL DEVELOPMENT IN EMERGING MARKETS: THE EGYPTIAN EXPERIENCE* (Mohamed El-Erian & Mahmoud Mohieldin ed. 1998).

119 Jun Quian & Philip E. Strahan, *How Law and Institutions Shape Financial Contracts: The Case of Bank Loans* (AFA 2005 Philadelphia Meetings Paper) (Available at SSRN: <http://ssrn.com/abstract=935927>); Abhiji v. Banerjee, *Contracting Constraints, Credit Markets and Economic Development*, (MIT Department of Economics Working Paper 02-17, 2001) (Available at SSRN: <http://ssrn.com/abstract=306990>).

2.3.1 Enterprise Finance in Africa: Demand for and Access to Credit

In a study of enterprise finance in Kenya, Marcel Fafchamps *et al.*,¹²⁰ sought to establish how information and enforcement problems affect firms' access to credit. They found differentiated access – small firms had difficulty accessing bank credit as only 43% of the 224 firms surveyed ever received a formal bank loan.¹²¹ However, they also found widespread use of alternative forms of enterprise finance, particularly trade credit. More than half of the 224 firms used trade credit, advances to suppliers, credit to customers, and advances by customers.¹²² In a similar study in Zimbabwe, trade credit was found to be the most important source of finance for firms (135 out of 200 firms), followed by loans from non-bank financial institutions such as pension funds, credit from government, and building companies.¹²³

A more recent study of Kenyan small scale enterprises also found that most firms do not use formal credit due to lack of information about credit and lack of collateral.¹²⁴ A much broader study by Bigsten *et al.*,¹²⁵ investigated the demand for and access to credit by firms in selected African countries (Kenya, Burundi, Zimbabwe, Cote D'Ivoire, Cameroon and Ghana). They found that large firms dominate the credit market and that the majority of loans were collateralized with high values of collateral (almost twice the value of the loan). However, on average the evidence showed that although few firms obtained formal credit (over 60% of the firms did not need credit), trade credit was widely used. Their findings suggest that widespread use of informal credit, particularly trade credit, accounted for limited use of formal credit.¹²⁶ However, smaller firms were clearly credit constrained because while they had more demand for formal credit, they experienced difficulty obtaining it.

120 Marcel Fafachamps *et al.*, Enterprise Finance in Kenya, Regional Program on Enterprise Development, Africa Region, The World Bank, (June 1994) (Available at <http://www.economics.ox.ac.uk/members/marcel.fafchamps/homepage/kenya.pdf>).

121 *Id.* at 34–40.

122 *Id.* at 40–45.

123 Marcel Fafachamps *et al.*, Enterprise Finance in Zimbabwe, 33 Regional Program on Enterprise Development, Regional Program on Enterprise Development, Africa Technical Department, The World Bank (April 1995) (Available at <http://www.economics.ox.ac.uk/members/marcel.fafchamps/homepage/zimba.pdf>).

124 Rosemary Atieno, Formal and Informal Institutions' Lending Policies and Access to Credit by Small Scale Enterprises in Kenya: An Empirical Assessment (37 African Economic Research Paper No. 111, 2001).

125 Arne Bigsten, *et. al.*, *Credit Constraints in Manufacturing Enterprises in Africa*. 12 Journal of African Economies, 104 (2003).

126 *Id.* at 108–13.

Other studies on credit markets in Africa have focused on issues such as fraud and the abuse of borrowers in unregulated microfinance markets,¹²⁷ credit flow to SMEs,¹²⁸ financial liberalization and access to rural credit,¹²⁹ the role of micro finance institutions in Uganda,¹³⁰ demand and supply for informal credit,¹³¹ micro credit and poverty alleviation.¹³² The studies establish that African firms face severe credit constraints. The widespread use of alternative forms of credit such as trade credit is not a phenomenon that indicates lack of demand for formal credit but rather the inability to access formal credit.

2.3.2 Contracting Practices of Firms in Africa

Formal credit markets cannot operate efficiently in the absence of contracts which determine the parties' rights, obligations, and remedies at various stages of a transaction. The design of credit contracts depends on the nature of the credit market, whereby the roles of the parties are often tailored to reflect which party can efficiently perform a particular function. Therefore, understanding firms' contracting practices is necessary to establish when formal contracts are used, as well as the rationale and substitutes for these contracts.

Contracting patterns in Africa reflect the difficulties of operating in an environment with weak legal institutions, the impact of economic and other shocks on formal exchange, and the role of mutual dependence and close interaction in mitigating risks of default. A study on contracting practices in Tanzanian industrial firms revealed the following patterns:¹³³

- (1) Social contacts and reputation played an important role in identifying business partners. Close to 38% of the surveyed firms established relations with suppliers

127 Catherine S.M Duggan, *Money from Strangers: Indirect Regulation in Developing Financial Markets* (2008) (Doctoral Thesis, Stanford University).

128 Julius Kakuru, *Loan Officers' and Clients Experiences in Credit Flow to SMEs in Uganda: A Research and Practical Perspective*, (January, 2007) (manuscript on file with the author).

129 Paul Mosley, *Micro- Macro Linkages in Financial Markets: The Impact of Financial Liberalization on Access to Rural Credit in Four African Countries* 11 *Journal of International Development*, 367 (1999).

130 Nannyonjo, Justin & Nsubuga James, *Recognizing the Role of Micro-Finance Institutions in Uganda* (Bank of Uganda Working Paper No. 04/01, 2004).

131 F.N Okurut, A. Schombee, & S. Van Der Berg, *Credit Demand and Credit Rationing in the Informal Financial Sector in Uganda* 73 *South African Journal of Economics* 482 (2005).

132 See Muhumuza, William, *Unfulfilled Promises? NGO's Micro-Credit Programs and Poverty Reduction in Uganda* 23 *Journal of Contemporary African Studies* 391 (2005); Hanak, Irmi "Working Her Way Out of Poverty": *Micro-credit Programs' Undelivered Promises in Poverty Alleviation* 16 *Journal fur Entwicklungspolitik* 303 (2000).

133 Satu Kahkonen, Lee Young, Patrick Meagher & Haji Semboja, *Contracting Practices in an African Economy: Industrial Firms and Suppliers in Tanzania*, (University of Maryland IRIS Centre Working Paper No. 242, 2001) (Available at <http://www.iris.umd.edu/download.aspx?ID=b88f8fd6-1735-446c-a2bb-8d3b308d6e7b>).

through business associations, while 21% did so through personal contacts (friends and family members). Only 15% of the firms established contacts through advertising and business directories—an indicator that impersonal or anonymous contact is very limited;¹³⁴

- (2) Mutually dependent relationships with suppliers built up over extended periods of time. About 48% of the firms indicated that they had a commercial relationship with a single supplier for over eight years. The relationships were largely informal but provided a basis for mutual trust and preventing opportunism;¹³⁵
- (3) Although most firms reported using some form of written documentation in transactions with suppliers and customers, none of the frequently used documents (receipts, bills of lading, invoices) amounts to formal contractual agreements;¹³⁶
- (4) Cash payments were widely used to minimize the risk of non-payment. In addition, where credit was used, average repayment periods were less than a month indicating a real absence of medium or long term credit;¹³⁷ and
- (5) Self enforcement, particularly direct bargaining with suppliers or customers, was the most frequent and effective method of contract enforcement. The choice of method depended on location (self- enforcement was frequently used by firms in Mwanza, while legal enforcement was more likely to be used by firms in Kilimanjaro), competition (stronger competition was associated with legal enforcement), the nature of the firm (African firms relied on self- enforcement while private foreign firms relied more on legal enforcement) and the nature of the dispute (supplier-related problems were more likely to be resolved using self- enforcement).¹³⁸

Other studies have also found evidence of widespread inefficiencies in legal enforcement. In a study on enforcement of commercial contracts in Ghana,¹³⁹ Fafchamps attributes difficulties in contract enforcement to information asymmetry as well as to exogenous shocks, such as difficulties in transport, late payments by customers, and fluctuations in income that make it difficult for firms to honor contractual obligations. He further states that these factors have fostered a culture of contract flexibility and contract renegotiation because businesses anticipate that sometimes parties will not be able to honor their obligations. He found that businesses minimize enforcement uncertainties by using cash as well as by contracting with parties with whom they had prior relationships.¹⁴⁰ Legal

134 *Id.* at 9–10.

135 *Id.* at 10.

136 *Id.* at 10–11

137 *Id.* at 11–12.

138 *Id.* at 16–20.

139 Marcel Fafchamps, *The Enforcement of Commercial Contracts in Ghana*, 24 *World Development* 427 (1996).

140 *Id.* at 444.

enforcement was limited to instances when breach was induced by a breakdown of relationships.¹⁴¹

Kinship ties and reputation are used to minimize contract uncertainties in Africa. A study on access to credit by firms in Kenya and Zimbabwe revealed that although ethnicity and gender did not play a role in access to formal credit, they influenced access to trade credit for Asian owned firms in Kenya and white owned firms in Zimbabwe, underlining the importance of network effects.¹⁴² Nkurunziza also argues that in Africa, deficiencies in formal legal institutions limit the usefulness of formal credit contracts and collateral when a borrower defaults, and that instead banks rely on reputation built through repeated transactions with creditors as an alternative contract enforcement strategy.¹⁴³ Therefore, although informal enforcement may sometimes be more efficient than legal enforcement,¹⁴⁴ it has limitations, particularly the inability to support informal exchange, which is critical for the development of formal credit markets. To the extent that parties continue to rely on informal sources of credit and informal contract enforcement, enterprise growth will be severely constrained because resources are not allocated efficiently.

2.4 “INNOVATIVE LENDING” AND THE ROLE OF MICRO CREDIT IN BRIDGING THE ACCESS GAP

Micro credit is not a new concept and the mechanisms for overcoming credit market imperfections, particularly information asymmetry and moral hazard, are similar to the ones historically used by non conventional bank institutions such as credit cooperatives. These mechanisms include use of social sanctions to prevent opportunistic behavior, repeated interactions among participants and delegated monitoring coupled with a monitoring incentive.¹⁴⁵ Timothy Besley,¹⁴⁶ refers to mechanisms such as those used in group lending in microfinance, and other similar arrangements as “non-market institutions”. They are used to enforce contracts in low

141 *Id.* at 446.

142 Marcel Fafchamps, *Ethnicity and Credit in African Manufacturing*, 61 *Journal of Development Economics* 205 (2000).

143 Janvier D. Nkurunziza, *supra* note 113.

144 Robert C. Ellickson, *Order Without Law: How Neighbors Settle Disputes*, 1991 (discussing the role of informal norms in dispute settlement in closely knit societies).

145 For a detailed discussion of monitoring incentives within the context of credit cooperatives see Abhijit V. Banerjee, Timothy Besley & Timothy W. Guinnane, *Thy Neighbours Keeper: The Design of a Credit Cooperative with Theory and a Test*, 109 *Quarterly Journal of Economics* 491 (1995).

146 Timothy Besley, *Nonmarket Institutions for Credit and Risk Sharing in Low- Income Countries*, 9 *Journal of Economic Perspectives* 115 (1995).

income countries because of their comparative advantages over legal enforcement. Below, I analyze the theories and empirical evidence on using such mechanisms to improve access to micro credit.

According to Maitreesh Ghatak and Timothy Guinnane, a financial institution must be able to perform four tasks in order to lend efficiently:¹⁴⁷ (1) ascertain the level of risk of default (the adverse selection problem), (2) ensure that the borrower will use the loan in a manner that maximizes the probability of repayment (the moral hazard problem), (3) monitor the borrower (the auditing problem), and (4) enforce repayment of the loan (the enforcement problem). The first two tasks are *ex ante* because they exist prior to lending, while the other two are *ex post*. The problem of adverse selection arises because lenders do not have adequate information about the quality of borrowers, and therefore, cannot distinguish between safe and risky borrowers. In developing countries, creditors are often not in a position to efficiently perform all the four functions. Therefore, credit contracts have been redesigned to assign duties to the party who can perform a particular function more efficiently. For example, in group lending transactions, screening, monitoring, and enforcement of contractual obligations are assigned to borrowers because they have more information than the lender, are able to monitor each other, and use social sanctions to enforce repayment.

Micro credit contracts are designed to mitigate the risks of two critical problems faced by lenders in imperfect credit markets —imperfect information and inefficient contract enforcement. The former creates an adverse selection problem, while the latter creates a moral hazard problem. Mechanisms designed to mitigate these risks and improve access to credit include peer/group lending, in which self selection mitigates the problem of adverse selection, and peer monitoring, which significantly reduces moral hazard. Other features inherent in the design of group lending contracts such as joint liability and the incentive of contingent credit also help to minimize moral hazard.

In their seminal paper explaining the existence of credit rationing, Joseph Stiglitz and Andrew Weiss¹⁴⁸ highlight the damaging effects of imperfect information on credit markets. The inability to distinguish between good and bad borrowers forces lenders to use interest rates as a screening tool. Lenders determine an optimum

147 Ghatak Maitreesh & Timothy W. Guinnane, *The Economics of Lending with Joint Liability: Theory and Practice*, 60 *Journal of Development Economics* 195 (1999).

148 Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 *The American Economic Review* 393 (1981).

lending rate beyond which they will not grant credit, even if borrowers are willing to pay higher interest rates. This is because beyond the optimal rate, the expected return to the lenders decreases as a result of the increased likelihood of default. Ultimately interest rates become inefficiently high, forcing good borrowers out of the market. Adverse selection, combined with lack of collateral, as is the case with micro enterprises in developing countries like as Uganda, leads to prohibitively high interest rates that discourage engaging in profitable investment opportunities.

The adverse selection problem in developing countries has been minimized by contractual arrangements that reduce the information gap between lenders and borrowers. An example is group lending in which, through a mechanism known as “assortative matching,” borrowers select their group members based on the information they have about each other. The selection happens during group formation when borrowers are able to use information available to them about each other, because of their geographical proximity, to select their members. Loan applicants will self select to avoid attracting high risk borrowers into their pool, hence reducing the probability of default.¹⁴⁹

The moral hazard problem arises when a borrower exploits the lender’s inability to monitor borrowers and engages in strategic default or undertakes a risky project with a higher probability of failure, thereby shifting the risk of default to the lender. Group lending, coupled with the threat of denial of future credit, creates an incentive for borrowers to monitor each other and minimize defaults.

The enforcement problem arises out of inefficiencies in legal systems that make it difficult to enforce contracts, such as corruption, high litigation costs, and delays in resolving disputes. Because the lender cannot rely on the legal system to enforce repayment, the task is shifted to the borrowers within a group, who are able to use social sanctions to punish default. The incentive to impose social sanctions arises out of the penalty imposed on the group when they have to repay the loan of a defaulting member. Sanctions include alienation, shaming, and withdrawal of cooperation, and their application may depend on the extent of harm suffered by the rest of the group because of the defaulting member’s failure to pay.¹⁵⁰

Empirical studies have attempted to explore the efficiency of mechanisms

149 Eric Van Tassel, *Group Lending Under Asymmetric Information*, 60 *Journal of Development Economics* 3 (1999).

150 Timothy Besley & Stephen Coate, *Group Lending, Repayment Incentives and Social Collateral*, 46 *Journal of Development Economics* 1, 9-13 (1995).

used by micro lenders to mitigate the risks of adverse selection and moral hazard. A study in Zimbabwe compared repayment rates of group and of individual loans and found that, under normal conditions, group loans perform better than individual loans. However, the group effect on repayment rates was found to significantly diminish when borrowers suffer external shocks like drought, in which case individual loans perform better. This finding was attributed to the diminished incentive to monitor when borrowers did not expect other group members to pay the loan.¹⁵¹ Other studies have analyzed repayment rates determinants including the effect of loan size, group size, and group self selection. A study in Thailand by Christian Ahlin and Robert Townsend¹⁵² found that small loans have a positive effect on repayment rates because they are less costly to pay back. In addition, progressive lending, using small amounts, ensures that only safe borrowers are eligible for successive large amounts. On the other hand, larger loans increase risks for the group members because the amount one would be required to pay for a defaulting member increases with the size of the loan.

Analyzing the effect of group size on repayment rates does not confirm conventional theory, which amplifies the positive effect of small groups on monitoring and repayment of loans. The results are at best ambiguous. A study in Bangladesh, by Sharma and Zeller¹⁵³ and another in Thailand by Ahlin and Townsend¹⁵⁴ found no effect of group size on repayment rates; however, in Madagascar, group size had a positive and significant effect of on repayment rates.¹⁵⁵ Aghion's¹⁵⁶ study provided mixed results showing that increased group size increases the incentive to monitor, reduces the per unit cost of monitoring, but negatively affects repayment rates because of the "free-rider effect". Other factors may have affected repayment rates in these studies. Guttman's¹⁵⁷ analysis of theoretical and empirical work on group lending concluded that, while the theories advanced pointed to the fact that group lending

151 Michael Bratton, *Financing Small Holder Production: A Comparison of Individual and Group Credit Schemes in Zimbabwe*, 6 Public Administration and Development 115 (1986).

152 Christian Ahlin & Robert M. Townsend, *Using Repayment Data to Test Across Models of Joint Liability Lending*, 117 Economic Journal F11-F151 (2007).

153 Manohar Sharma & Manfred Zeller, *Repayment Performance in Group Based Programs in Bangladesh: An Empirical Analysis*, 25 World Development 1731 (1997).

154 Ahlin & Townsend, *supra*, note 152.

155 Manfred Zeller, *Determinants of Repayment Performance in Repayment Groups: The Role of Program Design, Intra Group Risk Pooling and Social Cohesion*, 46 Economic Development and Cultural Change 599 (1998).

156 Beatriz Amendariz de Aghion, *On the Design of a Credit Agreement with Peer Monitoring*, 60 Journal of Development Economics 79 (1999).

157 Joel M. Guttman, *Repayment Performance in Group Lending Programs: A Survey*, (Networks Financial Institute Working Paper 2006-WP-01) (Available at SSRN: <http://ssrn.com/abstract=924363>).

shifts the screening and monitoring responsibilities to the party who can perform them more efficiently, empirical evidence on determinants of repayment rates is at best contradictory.

Group self selection is another factor that is widely considered to have a positive impact on repayment rates. The selection process occurs during group formation when individuals use their prior knowledge of each other to eliminate risky borrowers and prevent individuals with bad reputation from joining a group. Group members' knowledge is critical during the selection process.¹⁵⁸ Ghatak¹⁵⁹ demonstrates how self-selection improves repayment rates. He argues that because borrowers have more information than the lender, they know each other and the probability of success of their projects. Therefore, assortative matching eliminates risky borrowers and reduces the cost of credit for safe borrowers by eliminating risky borrowers from the group. He further states that by attracting less risky projects, group self-selection improves welfare from the point of view of aggregate social surplus. He also extends this welfare principle to a scenario in which the presence of safe borrowers reduces the cost of credit for risky borrowers because of the higher probability of success of safe projects. A study of group loan repayment performance in Bangladesh by Sharma and Zeller¹⁶⁰ found that indeed self-selection had a positive significant impact on repayment rates.

Aghion and Gollier¹⁶¹ advance a theory that extends the features inherent in group lending, particularly assortative matching, to group formations in which borrowers are uninformed about each other, such as in heterogeneous and highly mobile communities. In this case, safe and risky borrowers may end up in the same group. The theory envisages a cross subsidization effect, arising as a result of a pooling equilibrium that makes repayment rates random for both types of borrowers, hence reducing the extent to which risky borrowers can take advantage of being pooled with safe borrowers. There is, however, no empirical evidence that supports this theory.

Other studies have also found that group monitoring under joint liability lending reduces moral hazard. In his analysis of peer monitoring, Stiglitz¹⁶² argues that

158 Maitreesh Ghatak, *Joint Liability Credit Contracts and the Peer Selection Effect*, 110 *Economic Journal* 60(2000).

159 Maitreesh Ghatak, *Group Lending, Local Information and Peer Selection*, 60 *Journal of Development Economics* 27 (1999).

160 Sharma and Zeller, *supra*, note 153.

161 Beatriz Armendariz de Aghion & Christian Gollier, *Peer Group Formation in an Adverse Selection Model*, 110 *The Economic Journal* 632(2000).

162 Joseph E. Stiglitz, *Peer Monitoring and Credit Markets*, 4 *World Bank Economic Review* 351 (1990), reprinted in *The Economics of Rural Organization: Theory, Practice, and Policy* (Karla Hoff et., al, ed. 1993) 70-86, 78.

the obligation to repay loans for defaulting members in group contracts increases both the cost of borrowing and the risks for borrowers. However, he further states that this obligation creates an incentive for borrowers to monitor each other, and that to the extent that increased monitoring reduces the probability of default, it improves borrowers' welfare.¹⁶³ Aghion and Morduch¹⁶⁴ argue that high repayment rates in group lending cannot be solely attributed to the effect of joint liability, but may be explained by other factors inherent in this method of lending, such as client education and training, peer participation in the credit markets, and public repayments.¹⁶⁵

Some empirical studies are beginning to show that non-market institutions used in microfinance to extend credit in countries with weak information and contract enforcement mechanisms may not be as effective as heralded in earlier theoretical models. An example is the causal effect of joint liability on repayment rates. According to Aghion and Morduch,¹⁶⁶ joint liability in group lending is not necessary to ensure loan repayment, because other mechanisms including direct monitoring, regular repayment schedules, and non-refinancing threats, can achieve the same effect. They argue that group lending may be important, particularly in early stages for poorer clients, in as far as group meetings of clusters of clients reduce transaction costs of lenders reaching individual clients, induce repayment of loans through social stigma, level information asymmetry, facilitate education and training, and provide an opportunity for those with no prior banking experience to approach financial institutions alongside their peers. A field experiment conducted in the Philippines also revealed that joint liability is not the key determinant of repayment rates because no variations were found in the repayment rates of individual borrowers and of group borrowers. However, for the individual borrowers for whom the group structure was maintained purposes for other than joint liability, lending increased because more new clients joined the groups.¹⁶⁷

Some commentators have also suggested that the structure of group contracts may encourage borrowers to engage in less than optimal risk taking due to the fear of

163 *Id.* at 80.

164 Beatriz Armendariz de Aghion & Jonathan Morduch, *Microfinance Beyond Group Lending*, 8 *Economics of Transition* 401, 418 (2000).

165 Repayment of group loans is usually done at weekly meetings so failure to repay a loan becomes public information available to all group members. The threat of social stigma induces borrowers to repay their loans.

166 Beatriz Armendariz de Aghion & Jonathan Morduch, *supra*, note 164, at 416–417.

167 Xavier Gine & Dean S. Karlan, *Group Versus Individual Liability: A Field Experiment in the Philippines* CEPR Discussion Paper No. DP6193. (Available at SSRN: <http://ssrn.com/abstract=1134234>).

social sanctions that induce them to choose only safe projects that have a probability of a high return if the project succeeds.¹⁶⁸ On the other hand, the element of social insurance that is embedded in joint liability contracts may increase free riding and moral hazard. This phenomenon occurs when a member of a group does not work hard enough to ensure that his project succeeds because he knows that his loan will be repaid by group members whose projects do succeed. However, group self-selection may minimize this risk.¹⁶⁹

Conclusion

This chapter discussed the link between credit, financial development, and economic growth, as well as the factors that affect the cost of credit, thereby hampering the finance-growth nexus in some economies. These factors largely hinge on rule of law issues such as weak contract enforcement mechanisms and lack of creditor information. These factors increase the cost of credit for both lenders and borrowers. For lenders, costs include the risks of providing credit in an environment where they are unable to distinguish between good and bad borrowers, while being unable to rely on the legal system to enforce repayment of loans. For borrowers, the costs are a diminished credit supply and an increased cost of credit.

Governments have attempted to address these issues. However, an alternative approach has been promoted in the last decade or so using “innovative lending” methods in microfinance to mitigate the effects of adverse selection and moral hazard, thereby improving access to credit, particularly micro credit. In section 2.4, I have discussed both theoretical and empirical evidence of what these methods are able to achieve regarding these two problems. However, what is lacking in the literature and what I seek to do in this research, is to establish to what extent these methods have improved access to credit. In other words, to what degree do the “innovative lending” methods in microfinance alleviate the costs of accessing formal credit, specifically with regard to micro enterprises in Uganda.

168 Greg Fischer, Contract Structure, Risk Sharing and Investment Choice, MIT Job Market Paper, January 2008) (Available at <http://econ-www.mit.edu/files/2210>).

169 Xavier Gine, Pamela Jakiela, Dean S. Karlan & Jonathan Morduch (2006), *Microfinance Games*, (World Bank Policy Research Working Paper No. 3959, 2006) (Available at <http://go.worldbank.org/CK3HT-DZQD0>).

CHAPTER THREE

3.0 CREDIT MARKETS IN UGANDA

3.1 A PROFILE OF THE FINANCIAL SECTOR IN UGANDA: DUALISM IN THE FINANCIAL MARKET

The financial sector in Uganda is characterized by formal, semi-formal, and informal financial institutions. Formal financial institutions are incorporated as companies under the Companies Act and subject to prudential regulation by the Central Bank of Uganda.¹⁷⁰ They include commercial banks (classified at Tier 1 financial institutions), credit institutions (Tier 2), and microfinance deposit taking institutions (Tier 3). Tier 1 to 3 financial institutions are permitted to take deposits from the public, and provide credit and money transfer services. Formal credit institutions, particularly commercial banks, serve customers who operate largely within the formal sector, and their credit facilities are neither accessible nor affordable to micro enterprises. In 2008, 42.9% of the total commercial bank credit was extended to the services sector, followed by trade and commerce (18.1%), manufacturing (14.2%), building and construction (10.9%), transport and utilities (6.9%) and agriculture (6.9%).¹⁷¹

As of December 2008, there were 21 commercial banks in Uganda with a total branch network of 301 outlets across the country.¹⁷² The total assets of commercial banks as at the end of December 2008 was Ugshs. 7,555 billion and loans and advances stood at Ugshs. 3,405 billion.¹⁷³ The four credit institutions had 39 outlets,¹⁷⁴ total assets (excluding administered loans) of Ugshs. 106.6 billion and a total credit portfolio of Ugshs. 38.7 billion.¹⁷⁵ The bulk of loans from credit institutions were to trade and commerce (85%), followed by other services (7.1%) and building and construction (2.6%). As of December 2008, there were four microfinance deposit taking institutions with a total branch network of 96 outlets,¹⁷⁶ total assets of Ugshs. 123.6 billion and net loans of Ugshs. 8.1 billion.¹⁷⁷

170 Prudential regulation involves approval and licensing, as well as monitoring compliance with regulatory requirements such as capital adequacy, credit classification, liquidity, ownership and control.

171 Bank of Uganda Annual Supervision Report, (15 December, 2008) (Available at <http://www.bou.or.ug/bouwebsite/opencms/bou/supervision/asr.html>).

172 *Id.* at 2-3.

173 *Id.* at 11-12

174 One credit institution has recently been acquired by one of the newly licensed commercial banks, the Global Trust Bank of Nigeria. This leaves only three credit institutions in the Tier 2 category of financial institutions. See Nigeria Bank Buys Commercial Microfinance, *The New Vision*, 31 July 2008 (<http://www.newvision.co.ug/D/8/220/642397>). Bank of Uganda Annual Supervision Report, *supra* note 171 at 22.

175 Bank of Uganda Annual Supervision Report, *supra* note 171 at 22.

176 *Id.* at 29.

177 *Id.* at 29.

Semi-formal financial institutions are legally incorporated, but not regulated, and include savings and credit cooperatives that are registered and supervised by the Registrar of Co-operatives and District Co-operative Officer under the Uganda Co-operative Societies Act. Microfinance institutions that are either registered as companies, non-governmental organizations, or community based organizations are in the semi-formal category and are classified as Tier 4 financial institutions. Such institutions are not authorized to intermediate deposits from the public other than from their own members or as collateral for loans. Some of these institutions are members of self-regulatory bodies such as the Association of Microfinance Institutions of Uganda (AMFIU), the Uganda Co-operative Savings and Credit Union, and the Uganda Co-operative Alliance. Membership in these self-regulatory bodies is voluntary, and services to the members include training and capacity building, policy advocacy, standard setting, and codes of best practice on issues such as customer care, client charters, and corporate governance.

Informal financial institutions include Rotating Savings and Credits Associations (ROSCAs), Accumulated Savings and Credit Associations (ASCAs), Village Savings and Loan Associations (VSLAs), and other sources of informal credit that are neither registered nor regulated such as welfare funds, investment clubs and burial associations. They are often organized as unregistered groups in which membership is voluntary and the method of operation varies from one group to another. In addition to providing credit, the informal group members are able to accumulate savings, access emergency help, engage in joint activity, and receive training on personal development.

Table 2: Formal and Semi-Formal Financial Institutions in Uganda

Financial Institution	No.	Tier	Legal Status	Regulator
Commercial Banks	22	1	Incorporated	Central Bank
Credit Institutions	3	2	Incorporated	Central Bank
Microfinance Deposit Taking Institutions (MDI)	3	3	Incorporated	Central Bank
Microfinance Institutions	741★	4	Registered either as -Associations, -Companies, -Co-operatives, or -NGOs	Some are licensed but not subjected to prudential regulation

★ Based on a July 2006 census of Microfinance Institutions conducted by the Financial

Sector deepening project, supported by GTZ/SIDA but does not include those established after that date.

3.2 COMMERCIAL BANKS AND MICRO ENTERPRISE ACCESS TO CREDIT.

The Financial Institutions Act defines a commercial bank as “a company licensed to carry on financial institutions business in Uganda and whose principal business consists mainly in the acceptance of call, demand, savings, and time deposits withdrawable by check or otherwise, in the capacity of a bank, provision of overdrafts and short to medium term loans; provision of foreign exchange, participation in inter-bank clearing systems and the provision and assumption of guarantees, bonds and other warranties on behalf of others.”¹⁷⁸ Appendix I lists the commercial banks in Uganda as of September 2010 including the number of outlets, assets, deposits, and advances for each bank.

Commercial banks serve the high end of the credit market in Uganda. All banks maintain head offices in the capital city of Kampala, with branches in the major urban areas across the country. The outreach of commercial banks is very limited compared to that of microfinance institutions.¹⁷⁹ An analysis of credit facilities and requirements for obtaining credit indicates that their products are not suitable for micro enterprise finance, and that most micro enterprises cannot meet these eligibility requirements. Furthermore, the financial intermediation role of commercial banks is still low. As of December 2009, the total credit portfolio of commercial banks as a percentage of total bank assets was 45.1%.¹⁸⁰ A significant portion (42.5%) of the total assets of commercial banks were held in government securities (20.3%), financial institutions abroad (11.6%), cash and reserves with Bank of Uganda (10.6%).¹⁸¹ This asset distribution perhaps indicates commercial banks' risk perception of the credit market in Uganda. Although total credit as a percentage of total assets has been steadily growing from 34.1% in 2005, to 38.2% in 2006 and to 38.7% in 2007, the financial intermediation role of commercial banks in Uganda remains very low compared to the region.

178 S. 3 Financial Institutions Act, 2004 (Available at http://www.bou.or.ug/bouwebsite/export/sites/default/bou/bou-downloads/acts/supervision_acts_regulations/fia2004/FIA04.pdf).

179 Apart from Stanbic bank which has the widest branch network in the country with 66 branches and 140 ATMs, Barclays bank, following the acquisition of Nile bank, has 51 branches, Centenary bank has 42 branches and DFCU (U)L td 23 branches. The other commercial banks have less than 15 branches notably in various locations within Kampala and the major urban centers such as Entebbe, Jinja, Masaka, Mbale, and Mbarara.

180 Bank of Uganda Annual Supervision Report, *supra* note 171 at 12

181 *Id.* at 12.

Table 3: Regional Comparison of Commercial Banking Sectors

Country	No. of Banks	Total Assets	Total Credit	Credit as % of Total Assets
Uganda	21 (18 foreign & 3 local) -301 branches -328 ATMs (2007)	Ugshs. 7,555 billion	Ugshs. 3,405 billion	45.1%
Kenya	-44 (31 locally owned and 13 foreign owned) -996 branches -392 ATMs	Kshs. 1.35 trillion	Kshs. 757.8 billion	55.9%
Tanzania	-36 (13 foreign owned, 4 government owned, 13 locally owned and 10 mixed ownership)	TZs. 8,442 billion	TZs. 4,276 billion	50.7%
South Africa	-30 (17 local, 13 foreign)	R. 2,967 billion	R. 2,257 billion	76.1%

Source: Bank of Uganda Annual Supervision Report (December, 2008); Central Bank of Kenya Bank Supervision Annual Report, 9 (2009); Bank of Tanzania Directorate of Banking Supervision Annual Report, 6-7 (2008); Reserve Bank of South Africa Annual Supervision Report, 1-2 (2009).

Credit facilities of commercial banks include trade finance (letters of credit, guarantees, and overdraft facilities for working capital), term loans, business loans, lease facilities, and consumer or personal finance loans such as employer guaranteed loans and mortgage finance. Credit to the services (42.9%), trade and commerce (18.1%) and manufacturing (14.2%) sectors accounts for the largest proportion of total commercial bank lending, while agriculture, transport, and building and construction account for the least.¹⁸² Loan durations vary from 18 to 36 months at prime lending rates from 16 to 23%, depending on the banks' risk analysis of a borrower. The lending requirements include: ownership of an ongoing business; business incorporation

¹⁸² Distribution of commercial bank credit by sector, Bank of Uganda Annual Supervision Report, *supra*, note, 171 at 11

documents where applicable; directors' resolutions to borrow; financial statements of the business; cash flow statements and business projections; bank statements; and collateral whose value should be between 130% and 150% of its forced sale value. In addition, all the banks preferred to have a pre-existing relationship with the borrower because an assessment of the client's banking transactions is critical prior to lending and during the course of the loan as a monitoring tool. The amount of money required to open a business checking account ranges from Ugshs. 50,000 to 200,000.¹⁸³

The interviews with selected commercial banks clearly showed that the banks prefer to lend to multi-national corporations, large local companies and institutions, and high net-worth individuals because these borrowers are easier to monitor and considered less risky. Over the last couple of years, some banks have started to aggressively lend to Small and Medium Enterprises. This development is partly driven by competition and partly by a new perception about small businesses.¹⁸⁴ However, banks remain very selective, preferring to lend to SMEs that have a track record, substantial security, and a pre-existing relationship with the bank. The adoption of lending methods, such as financial statement lending,¹⁸⁵ asset based lending,¹⁸⁶ factoring, and small business credit scoring¹⁸⁷ have made it possible for commercial banks to extend credit to SMEs.

Micro enterprises have difficulty accessing credit from commercial banks due to several factors including: (1) the fluidity of micro enterprises makes it difficult for them to have a track record, (2) the majority require small loans to finance working capital that are not considered viable by the commercial banks, (3) micro loans require intensive processing and monitoring that banks are reluctant to do, (4) lack of collateral, (5) micro enterprise owners generally are not familiar with the operations of commercial banks, and (6) limited geographical outreach of commercial banks.

183 Other requirements for opening a business checking account include formal identification documents such as business incorporation documents, directors' resolutions, identification of key officers, trading license, tax identification number, and signature mandates.

184 "Banks Turn to Informal Sector," *The New Vision Newspaper*, September 17, 2008 at p.36 (Reporting that commercial banks which, for several years focused on corporate clients, have been forced by competition to turn to the informal sector. The article further reported that several banks were involved in the drive to provide affordable banking services to SMEs, including opening branches in areas dominated by SMEs and informal businesses such as the Kikuubo, Shauri Yako, St. Balikuddembe and Kisenyi markets).

185 Banks usually require a loan applicant to submit financial statements for the previous two to three years as well as cash flow statements. To ensure the accuracy of financial information, some banks maintain a list of preferred auditors. In addition, financial statements are often analyzed together with other information such as bank statements and tax returns.

186 Banks require the borrower to pledge assets such as inventory and accounts receivable as security for a loan. In addition, leasing is widely used for asset acquisition financing.

187 Most banks have developed tools used to appraise SME loan applicants based on factors such as business track record, ownership, nature of business, character, and capacity to repay a loan.

3.2.1 Stanbic Bank (U) Ltd – “Inspired, Motivated, Involved”

Stanbic Bank (U) Ltd, (Stanbic) has historical roots in Uganda dating from as far back as 1923 when the National Bank of India started operations as a foreign registered bank. In 1957, the National Bank of India amalgamated with the Grindlays Bank to form the National Overseas and Grindlays Bank Ltd, which subsequently changed its name in 1959 to National and Grindlays Bank Ltd, and in 1969 to Grindlays Bank (Uganda) Ltd. In 1992, Standard Bank Group, through its investment arm Stanbic Africa Holding Limited (SAHL), acquired the Grindlays Africa Network, including Grindlays Bank (Uganda) Ltd. It adopted the Stanbic Bank name in 1993 with a shareholding of 51% held by SAHL and 49% held by the Government of Uganda. In 1996, the Government of Uganda sold its 49% shareholding to SAHL, making SAHL the sole owner of the company. In 2002, Stanbic acquired an 80% shareholding in the previously state owned Uganda Commercial Bank, and subsequently the two banks were merged, with the Government of Uganda acquiring a 10% stake in Stanbic.

Prior to the acquisition of Uganda Commercial Bank, Stanbic was a traditional corporate bank with two branches in Kampala. However, following the acquisition, the bank's strategy shifted to providing a wide range of wholesale and retail banking products and services, hence becoming Uganda's largest financial institution with the widest branch network and most ATM locations. In 2006, SAHL and the Government of Uganda each offered 10% of their shareholding in Stanbic to the public through an initial public offering, and the bank was subsequently listed on the Uganda Securities Exchange. The bank's vision is to make a real difference by providing financial services in Uganda, ensuring long-term sustainability by harmonizing the needs of its customers, people and shareholders as well as being relevant to the societies in which it operates. Stanbic's values include “serving our customers, growing our people, delivering to our shareholders, being proactive, team work, respect and integrity.”¹⁸⁸

In December 2009, Stanbic had assets of Ugshs. 1,880,513,222,000 with 66 branches and 140 ATMs countrywide. Customer deposits stood at Ugshs. 1,459,424,768,000 and loans and advances to customers stood at Ugshs. 927,373,277,000 representing 49.3% of its total assets.¹⁸⁹ The low level of loans and advances was attributed to competition and the bank's slow transition into

¹⁸⁸ Stanbic Bank Uganda brochure.

¹⁸⁹ Stanbic Bank Financial Statements for the year ended December 31, 2009, Stanbic Bank, Annual Report and Financial Statements, 2009

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the retail market, which was perceived as high risk. However, this has been steadily increasing over the years. In 2007, it was 36% and 45.8% in 2008. The bank's portfolio at risk as of August 2008 was 0.75%. Stanbic offers a range of financial products and services including personal banking, business, corporate, and investment banking. Personal and business banking products include mortgage lending, vehicle and asset financing for personal customers and for businesses, card products (visa debit card service), transactional products (deposit-taking, electronic banking, checking accounts), and bancassurance (short and long term insurance products and financial planning services provided to customers mainly through third parties). Corporate and investment banking products include global markets, banking and trade finance, and investment banking. In addition, Stanbic is one of the primary dealers in Government of Uganda securities.

In terms of credit facilities, Stanbic has both wholesale and retail products. The latter are mainly personal consumer loans and loans for small and medium enterprises. Personal consumer loans are divided into three categories. The first category is loans to individuals who are eligible to borrow amounts ranging from Ugshs. 120,000 to 1,000,000. The second category loans range from Ugshs. 1,000,000 to 2,000,000. The repayment period for these two categories ranges from six to 48 months. The third category offers loans to affluent customers and ranges from Ugshs. 2, 000,000 to 36,000,000 and the repayment period is from six months to five years. All three categories are largely employer guaranteed loans. The requirements for obtaining a loan include proof of monthly income and confirmation by the loan applicant's employer that the loan applicant is their employee and that his or her salary will be remitted to the bank. These loans are unsecured. The interest rate charged on these loans ranges from 16 to 24% per annum.

Small and medium enterprise loans range from Ugshs. 2, 500,000 to 250,000,000 and include overdraft facilities for working capital finance, tax clearance loans, term loans, bank guarantees, and letters of credit. The requirements for obtaining a loan vary depending on the relationship a borrower has with the bank. A prior relationship with the bank will enable credit officers to consider facts such as timely repayment of previous loans and banking records. In cases in which the bank is uncertain about the borrower and the amount required exceeds Ugshs. 36, 000,000, then collateral will be required. When collateral is required, the bank's policy is not to grant a loan that exceeds 80% of the collateral's value. The interest rate charged on SME loans ranges from 16 to 24% per

annum depending on the perceived risk of the borrower. The bank's prime lending rate is 16%. Loans are categorized as short term (two years), medium term (five years) and long term (up to 20 years). The majority of SME borrowers are unincorporated sole proprietorships. Obtaining information and keeping track of these entities is difficult so a pre-existing relationship with the bank is critical for evaluating loan applications. Credit officers usually rely on information about a borrower's credit and transactions history provided by branch officers.

Wholesale loans are largely corporate investment banking products and include overdrafts, loans, letters of credit, and bank guarantees for corporations. The bank perceives borrowers in this category to be very low risk because they operate in the formal sector which facilitates obtaining information about borrowers and their directors, revenues, assets and financial records.

Unlike other banks in which loan approval is decentralized and individual credit officers and branches have maximum limits on loan amounts that they can approve, loan approval at Stanbic is centralized. Loan applications are received and processed at branches and sent to the head office for approval. Consumer loans are processed online and may be approved within three working days; with other loans, the applicant may receive a notification of approval within five working days. However, disbursement of the loan depends on how long it takes to register a mortgage or perfect security. This process is usually slow and may take two weeks to as long as three months.

As mentioned earlier, before acquiring Uganda Commercial Bank, Stanbic largely focused on corporate investment banking and had a small retail portfolio. This strategy was due to the bank's perception that retail lending was high risk, involving numerous transactions but low per unit volumes. However, competition in the corporate investment banking market, technology, and improved methods of screening and monitoring retail borrowers have made it possible for the bank to engage in retail lending. Currently, retail loans account for 48% of Stanbic's loan portfolio.

3.2.2 Centenary Bank – “*Our Bank...*”

Centenary Bank is a Tier 1 licensed and locally owned commercial bank and the only commercial bank that provides microfinance services. The bank's origins stem from an initiative of the Uganda National Council of Lay Apostolate of the Catholic

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Church, designed in the early 1980's to provide appropriate financial services to the rural population. In 1983, the Centenary Rural Development Trust was registered as a financial institution, but commenced operations in 1986, and subsequently transformed into a commercial bank in 1993. The bank's shareholders are the Catholic Dioceses of Uganda (38.6%), the Uganda Catholic Secretariat (31.3%), the International Solidarity for Development and Investment -- SIDI (11.6%), Stichting Hivos-Tridos Fonds (18.3%), and individuals (0.3%). The bank aims to provide financial services, especially microfinance, to all people in Uganda, particularly in rural areas, and is predominantly a commercial micro bank with microfinance customers accounting for 90% of its customer base. This is in line with its vision of becoming Uganda's best microfinance provider. However, due to increased competition and as a risk mitigation measure, the bank has diversified its activities to include lending to SMEs and large corporations, as well as high net-worth individuals. Centenary bank's values include professionalism, leadership, excellence, superior customer service, integrity, and team work.¹⁹⁰

Centenary bank's services include credit facilities (business and consumer credit, agricultural credit, and asset acquisition loans) and transaction services (deposit accounts, electronic banking, money transfer services, bank guarantees, and performance bonds. As of December 31, 2009, the bank had assets of Ugshs. 582,668,799,000, total deposits of Ugshs. 448,308,570,000, and gross loans and advances of Ugshs. 354,632,693,000, representing a loan to deposit ratio of 77.4%. Micro loans constituted 21.5% of the bank's gross loan portfolio. The bank had 36 branches and 71 ATMs across the country.

The amount required to open a checking account at any of Centenary bank's branches varies from Ugshs. 10,000 for a personal savings account, to Ugshs. 100,000 for a personal current account, while entities such as sole proprietorships, partnerships, companies, and NGOs require a minimum of between Ugshs. 200,000 to 300,000. Other requirements include valid identification, recommendation letters from an account holder and a local council chairman of the area where one resides, utility bills, a trading license, incorporation documents, and board resolutions (if applicable).

Centenary bank's credit facilities are primarily consumer and business loans. The former are mainly home improvement loans and employer guaranteed loans. Business loans include micro business loans (up to a maximum of Ugshs.

190 <http://www.centenarybank.co.ug/about-centenary-bank.php>.

15,000,000), agriculture loans (amounts vary depending on the borrower's repayment capacity), commercial/SME/corporate loans (working capital loans, overdrafts, short and medium term development loans, and trade finance). Loan requirements vary depending on the type of loan. Micro business loans are largely for financing working capital and asset acquisitions. They range from a minimum of Ugshs. 100,000 to 15,000,000. The bank further categorizes micro business loans into "micro loans" where the maximum amount one is eligible to borrow is Ugshs. five million and "micro small business loans" which range from Ugshs. five million to 15 million.

Although micro business loans constitute a significant portion of the bank's loan portfolio, the majority of micro business loans are below Ugshs. five million. The requirements for a micro business loan include ownership of an on-going business, collateral or movable chattels, a checking account with the bank, a guarantor, payment of a loan application fee of Ugshs. 5,000 and a commitment fee of 2% of the loan amount.¹⁹¹ Unlike other microfinance institutions that provide credit either on an individual or a group basis, Centenary bank provides credit on an individual basis only. Although all loans require collateral, a legal mortgage is executed only for loan amounts above Ugshs. 5,000,000, while lesser amounts are secured by equitable mortgages.

The procedure for approving loan applications varies depending on the nature of the loan. However, micro loans are processed at the bank branches where the applications are submitted, and each branch has a limit depending on the size of the branch, but not exceeding Ugshs. 15 million. Loans of up to Ugshs. 100 million are approved by the head office credit committee, while loans of between Ugshs. 100 to 500 million are approved by the management credit committee, and the board risk and credit committee approves loans above Ugshs. 500 million. Therefore, considering that the maximum amount for micro loans is Ugshs. 15 million and the majority of micro loans are below Ugshs. 5 million, the approval process is simple and quick. For first time borrowers, the approval process may take up to five days while repeat borrowers will usually have their loan applications processed within 24 hours. The approval process is much more elaborate for SME and corporate loans, and may take up to three weeks for first time borrowers.

For micro loans, the majority of borrowers are individuals owning micro enterprises that are usually not formally registered and engage in retail business.

¹⁹¹ The requirements for micro business loans are less onerous than those for corporate and SME loans, which require the borrower to submit audited financial statements, board resolutions, cash flow statements, business incorporation documents, proof of ownership of collateral, and collateral valuation reports.

Due to the nature of micro enterprises, verification of the business and ownership of chattels is done by informal means, including visiting the business premises, using trading licenses as proof of business ownership and using sale agreements as evidence of ownership of unregistered land and chattels. Micro loans are repayable within a maximum of two years. However, the majority of the loans have a shorter repayment period, usually less than one year. The interest rate for new borrowers is 22% per annum, plus a monitoring fee of 2% of the loan value. The monitoring fee for repeat borrowers is reduced to 0.5% of the loan value.

All eight banks that I interviewed are engaged in SME financing. Two of the banks indicated that they considered themselves SME banks. The demand for credit is largely for purposes of working capital finance (commercial advances and overdraft facilities), and these are short term loans (usually under 12 months). Other credit facilities include trade finance and asset acquisition loans, but their volume is much smaller than that of commercial advances and overdraft loans. Only one bank (Centenary bank) is involved in micro lending. As illustrated by the two case studies above, Stanbic bank is the largest financial institution in the country, both in terms of its assets and branch network. It is also able to intermediate deposits on a large scale because of its extensive network and the minimal requirements for opening a bank account enhance its capacity to mobilize deposits. However, Stanbic bank does not provide microfinance services. On the other hand, Centenary bank has positioned itself as a microfinance bank and low income individuals as well as small businesses, can access its banking services and credit facilities. Close to 74% of its customer base are in the rural areas and considering its strategy, it has the potential to provide financial services that are needed by the economically active poor.

3.3 CREDIT INSTITUTIONS AND MICRO ENTERPRISE ACCESS TO CREDIT

Credit Institutions are classified as Tier 2 financial institutions. A credit institution is defined as “any company licensed to carry on financial institutions business in Uganda which is specified in the second schedule to the Act as its principal business, and any other body specified by the Central Bank to be a credit institution and includes all branches and offices of that company or body in Uganda.”¹⁹² The second schedule to the Financial Institutions Act provides that the main financial services provided or business conducted by a credit institution is acceptance of call and

192 S. 3 Financial Institutions Act, 2004.

time deposits that are repayable after a fixed period or after notice and employment of such deposits, wholly and partly, by lending or by any other means for the account and at the risk of the person accepting such deposits.

3.3.1 Commercial Microfinance (U) Ltd – “Secure Savings, Easy Loans”¹⁹³

Commercial Microfinance (U) Ltd (CMF), was a credit institution founded in 2000 that currently has eight branches (four within various locations of Kampala and four in other towns across the country) as well as 13 agency offices. As of December 2007, CMF had assets of Ugshs. 33,275,088,000, loans and advances to customers of Ugshs. 17,165,155,000, and deposits of Ugshs. 20,665,347,000.¹⁹⁴ CMF’s vision is “to become a leading provider of financial services that is dedicated to helping the mass market segment.” Its mission is “to build a secure and transparent institution that provides financial services to the mass market through a growing branch network.” CMF’s values include: honesty and integrity, understanding and helping their customers, and respect for customers, suppliers and each other.¹⁹⁵

CMF’s services included savings and deposit accounts, credit facilities, money transfer services, standing orders for payments, and safe custody facilities. The savings accounts include the CMF ordinary savings, which requires a minimum of Ugshs. 10,000, the CMF Easy Saver, which requires a minimum of Ugshs. 100,000, the CMF Junior Savings, which requires a minimum of Ugshs. 1,000, the CMF Fixed Deposit, which requires a minimum of Ugshs. 5,000,000 and the CMF Premium Savings. The credit facilities included business and consumer loans. The former are SME loans, individual small business loans, and group loans, and the latter are salary loans to employees and education loans.

SME loans varied from Ugshs. 20 and 100 million. The majority of SME loans are between Ugshs. 20 to 50 million charged at an interest rate of 2.5% per month. Loan requirements included ownership of an ongoing business for at least one year prior to applying for the loan, collateral of at least 150% of the value of the loan, guarantors, and cash flow statements, and the repayment period is up to 24 months. A large proportion of CMF’s loan portfolio (approximately 75%) was comprised of individual business loans in which the borrowers are engaged in small business activity. These loans were obtained largely to finance working capital. The average loan amount was Ugshs. 1.2 million and the average loan duration

193 At the time of underrating the research in 2007, Commercial Microfinance was a tier 2 financial institution. However, in 2008 it was acquired by Global Trust Bank.

194 Commercial Microfinance Financial statements for the year ended 31 December 2007, in, *The New Vision Newspaper*, 28 April 2008 at p.10.

195 <http://cmf.co.ug> (accessed 6/19/2008).

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was 12 months. The interest charged on these loans was 2.5% per month. The requirements for an individual business loan were: cash flow statements, a banking relationship with CMF for at least one month or credit history from another financial institution, proof of business ownership (using business registration documents, or a trading license, or letter from a business association of which the business is a member, or letter from the local council chairman of the area in which the business is located). Loan appraisal officers independently verified the information provided by the loan applicant. They conducted scheduled and unscheduled visits to the business premises, and gathered information about the business owner from sources such as newspapers, neighbors, and other clients.

In addition to the above requirements, borrowers were required to pay a loan application fee of Ugshs. 20,000, a loan processing fee of 2% of the loan amount, a loan insurance fee of 1.2% of the loan amount (or 0.8% for group loans). Other fees included a title verification fee of Ugshs. 40,000 or Ugshs. 25,000 if title is a motor vehicle log book, and a mortgage registration fee of Ugshs. 100,000 for loan amounts below Ugshs. 10 million and an additional 0.5% of the loan amount if the loan was above Ugshs. 10 million.

Monitoring of borrowers was done by credit officers. CMF had 60 credit officers out of a total of 200 staff. Each creditor had responsibility of about 150 to 300 clients. They monitored borrowers' accounts, cash flows, visit their business, premises and gathered any useful information about borrowers. CMF's portfolio at risk was rather high at 8-15%, compared to other financial institutions because it accumulated non-performing loans during a period of rapid expansion. To minimize defaults, screening of new borrowers was quite rigorous. Due to numerous non-performing loans in the preceding years, CMF adopted a conservative approach to lending, particularly for first time borrowers, whereby it initially advanced small amounts and increases the value of subsequent loans. In addition, for unregistered collateral and chattels, CMF minimized risk by not granting credit in excess of 30 to 40% of the value of the collateral and by requiring the borrower to provide additional security. For example, when the borrower pledged a chattel, CMF would require either a guarantor or unregistered land as additional collateral.

Credit institutions are second tier financial institutions, and although the requirements for obtaining credit are less rigorous than those for commercial banks, the majority of micro enterprises would be constrained to obtain credit from such institutions. These institutions have a much smaller outreach than any category of financial institutions in Uganda. Moreover credit facilities that have been designed for small businesses such as the CMF Business (duka) loan and the Post Bank biz loan, are more suitable for small enterprises that are in the SME

category. The average loan amounts for the CMF Business (duka) loan and the Post Bank biz loan are Ugshs. 1.2 million and Ugshs. 2 million respectively. These amounts are higher than the average loan amounts for micro enterprises. Notably, although some credit institutions provide group loans that can be accessed by micro enterprises, CMF has made a strategic decision to downsize this product because of the high cost of monitoring groups and the fluidity of micro enterprises. In addition, their experience indicates that group loans work best in rural settings, as opposed to urban ones where most credit institutions are located. They attribute this phenomenon to the high mobility of individuals within urban centers which is unfavorable to group lending.

3.4 MICROFINANCE DEPOSIT TAKING INSTITUTIONS AND MICRO ENTERPRISE ACCESS TO CREDIT

A microfinance deposit taking institution (MDI) is defined as “a company licensed to carry on, conduct, engage in, or transact microfinance business in Uganda.”¹⁹⁶ Microfinance business is the business of accepting deposits from and providing short term loans to small micro enterprises and low income households, and is usually characterized by the use of collateral substitutes, such as group guarantees.¹⁹⁷ As of December 2008, Uganda had three licensed microfinance deposit taking institutions with 96 outlets throughout the country, a combined asset base of Ugshs. 123.6 billion, deposits of Ugshs. 31.5 billion, and net loans of 81.1 billion.¹⁹⁸

3.4.1 PRIDE (Microfinance Deposit-Taking Institution) Ltd - “Your Growth is our Pride”

PRIDE Uganda started in 1995 and has its roots in Kenya where PRIDE was first established in 1986 by a former American Peace Corps Volunteer. It started as a microfinance institution providing credit to its clients mainly through the group guarantee loan scheme, and subsequently became a microfinance deposit taking institution in 2005. PRIDE has its headquarters in Kampala with 29 outlets¹⁹⁹ spread across the country, and its policy is to serve clients within a radius of seven kilometers of a branch location. PRIDE’s mission is to become the leading microfinance deposit taking institution in Uganda. Its mission is to create a financial and information services network for small and medium scale entrepreneurs, to increase incomes and employment by conducting sustainable and profitable operations that cater to and fully satisfy the needs of its clientele, and to promote the growth and welfare

¹⁹⁶ *Id.* s.3; s.2 Micro-Finance Deposit-Taking Institutions Act, 2003.

¹⁹⁷ S. 3 Financial Institutions Act, 2004; S.2 Micro-Finance Deposit-Taking Institutions Act, 2003.

¹⁹⁸ Bank of Uganda Annual Supervision Report, *supra*, note 171 at 29.

¹⁹⁹ PRIDE has 12 outlets in the central region, 6 outlets in the eastern region 9 outlets in the western region and 2 outlets in the north and northwestern regions.

of its staff and the development of the communities in which PRIDE operates.

In 2007, PRIDE had 56,300 active loan clients, 50% of whom were women, and 33,432 of whom were clients in rural areas with savings of Ugshs. 17.4 billion, of which Ugshs. 8.5 billion were voluntary savings, and Ugshs. 8.9 billion were forced savings (loan insurance fund). In terms of size, as of 31 December 2009, PRIDE's assets stood at Ugshs. 66,083,274,000, its loan portfolio was Ugshs. 47,805,118,000.²⁰⁰

PRIDE offers a range of financial services including deposit mobilization, credit facilities, and money transfer services. In terms of credit facilities, PRIDE has group guarantee loans, individual loans, and consumer loans. Group guarantee loans attract the most customers but have a smaller portfolio volume compared to individual loans. The loans offered under the group guarantee scheme range from a minimum of Ugshs. 200,000 to a maximum of 10,000,000. The average loan duration is between ten to eleven months. However, the repayment period for group guarantee loans is 25 to 50 weeks depending on the amount borrowed. Loans obtained on an individual basis range from Ugshs. 500,000 to Ugshs. 100,000,000. As of 31 December, 2007, the average outstanding loan as a percentage of GDP was at 129%.

Table 4: PRIDE Microfinance Group Guarantee “Loan Menu”

Loan Amount	Weekly Loan Repayment	Weekly Compulsory Deposit/Saving	Repayment period in weeks
200,000/=	9,200/=	2,200/=	25
500,000/=	15,000/=	2,200/=	40
800,000/=	20,800/=	2,200/=	50
1,200,000/=	31,200/=	2,200/=	50
1,800,000/=	45,500/=	2,200/=	50
2,500,000/=	65,500/=	2,200/=	50
4,000,000/=	100,000/=	2,200/=	50
6,000,000/=	150,000/=	2,200/=	50
8,000,000/=	200,000/=	2,200/=	50
10,000,000/=	250,000/=	2,200/=	50

Source: Pride Microfinance Loan Brochure

200 Pride Microfinance LTD (MDI), Financial Statement Extracts for the Year Ended 31 December 2009, in the New Vision Newspaper, Tuesday 27 April 2010 at p.44.

Table 5: Requirements and Benefits for Group Guarantee Loans and Loans Obtained Individually

Source: Pride Microfinance Loan Brochure explaining loan products

3.4.2 FINCA (U) Ltd (MDI) – “*Small Loans Big Changes*”

FINCA originated in Latin America in 1984 and has a presence in several African countries including Uganda. FINCA Uganda, a wholly owned subsidiary of FINCA International was registered as a company and Non-Governmental Organization (NGO) in 1992. It started out by providing microfinance services exclusively to women, who accessed credit through groups until 2005, when it converted into a microfinance deposit taking institution and also started providing services to men. FINCA has its headquarters in Kampala and has 22 outlets spread across the country. Its policy is to serve clients within a radius of 30 kilometers of a branch location. FINCA was the first microfinance institution to be licensed as a microfinance deposit taking institution supervised by the Bank of Uganda. Its mission is to provide financial services to Uganda's lowest income entrepreneurs so that they can create jobs, build assets, and improve their standards of living. Its vision is to serve more low-income entrepreneurs than any other microfinance institution in Uganda while operating on commercial principles of performance and sustainability. FINCA's core values include professionalism, team work, customer focus, concern for the poor, enterprise and innovation.

FINCA has over 41,000 active loan clients, with over 2,000 village banking groups, 75% of whom were women. Approximately 80% of its clients are in rural areas. As of December 2007, FINCA's savings stood at Ugshs. 6, 888,099,000, of which Ugshs. 5.9 billion were voluntary savings and Ugshs. 0.9 billion were forced savings (loan insurance fund). Its portfolio at risk is under 3%. In terms of size, in December 2009, FINCA's had assets of Ugshs. 33,376, 459,000, its loan portfolio stood at Ugshs. 23, 791, 037.²⁰¹

FINCA's source of loanable funds includes funds from its parent company (FINCA International), donor funds, and commercial borrowings from financial institutions such as commercial banks and deposits. It offers a range of financial services including credit facilities, money transfer services, deposit accounts, and corporate accounts. In terms of credit facilities, FINCA has group guarantee loans and individual loans (the latter include salary guaranteed loans, business loans and fixed asset loans). The group guarantee loans attract the most customers but have a lower portfolio volume compared to the individual loans. The loans under the group guarantee scheme range from a minimum of Ugshs. 50,000 (\$25) to a maximum

201 FINCA (U) Ltd (MDI), Financial Statement for the Year Ended 31 December 2009, in The Daily Monitor Newspaper, Tuesday April 6, 2010 at p.38.

of Ugshs. 6,000,000 (\$ 3000). The repayment period for group guarantee loans is four to six weeks, depending on the amount borrowed, and interest rate charged is 3% per month.

The clientele of microfinance deposit taking institutions represents a section of the population that was previously unable to access commercial bank credit. The loan products are tailored to suit the credit needs of poor households and small businesses. The requirements for obtaining a loan, and the methods of screening and monitoring borrowers reflect the dynamics of micro lending, particularly informal information gathering, relationship lending, use of collateral substitutes, and social capital. In Chapter 6, I provide a detailed discussion of the lending methods used by micro credit providers.

3.5 MICROFINANCE INSTITUTIONS (NON-DEPOSIT TAKING) AND MICRO ENTERPRISES ACCESS TO CREDIT

Microfinance institutions include the microfinance deposit taking institutions (Tier 3 MDIs) and those that are not authorized to take deposits from the public (except their members or as collateral for a loan). The former are discussed above, and the latter are largely institutions commonly referred to as Tier 4 MFIs. A 2006 census of MFIs in Uganda revealed that there were 741 microfinance institutions (including MDIs) and 1,064 microfinance outlets.²⁰² Out of the 741 MFIs, 628 were Savings and Credit Cooperatives (SACCOs), 82 were companies, 24 were NGOs and seven were Tier 1-3 MFIs. SACCOs are registered under the Uganda Co-operatives Societies Act, and lend to their own members who own, finance, and control these institutions. Some MFIs operate as companies or associations registered under the Companies Act, while others operate as NGO's or Community Based Organizations (CBO's) that are usually registered as companies limited by guarantee and as NGOS/CBOs by the Non-Governmental Organizations Board under the Non-Governmental Organizations Registration Act. The ones that operate as Money Lenders are registered and licensed by Magistrates Courts under the Money Lenders Act.

202 Luke Okumu, Preliminary Results of the Census of Microfinance Institutions in Uganda. (Available at http://www.fsdu.or.ug/pdf/Preliminary_Results_Census_of_MFIs_in_Uganda.pdf) (Accessed 1/22/2007). The census considered MFIs registered under the Companies Act, the Cooperatives Societies Statute, the Non-Governmental Organization Act, and the Money Lenders Act.

3.5.1 FAULU (U) Ltd - Non-Deposit Taking Microfinance Institution²⁰³

FAULU is a Swahili word meaning success. This MFI started business in Uganda in 1995 and had nine outlets (four of which are in Kampala and the rest in the major towns of Mbarara, Masaka, Jinja, and Iganga). It had assets of Ugshs. ten billion. The credit facilities included business loans and consumer loans, which are lent either on an individual or a group basis. FAULU had over 17,000 active borrowers, a majority of whom are female. Group guarantee loans were in the range of Ugshs. 200,000 to 2,000,000 with an interest rate of 36% per annum, and individual loans from Ugshs. 800,000 to 20,000,000 with an interest rate of 24% per annum. The loan repayment period was up to a maximum of 24 months.

The requirements for a group guarantee loan included: (1) membership in a five to six person group whose members operated in the same location, (2) the applicant was required to reside within a five kilometer radius of the branch location, (3) ownership of an existing business, (4) attendance at client training sessions, (5) savings of up to 25% of the loan amount, and (6) a recommendation letter from the local council chairman of the area where the applicant was resident. Group guarantee borrowers were given a grace period of two weeks following disbursement of the loan, and, thereafter, were required to make weekly repayments as well as save at least Ugshs. 2,000 every week. On the other hand, the requirements for individual loan applicants were much more onerous including: (1) bank statements, (2) guarantors, (3) a trading license, (3) collateral or savings of up to 30% of the loan amount, (4) business records (sales and purchases), (4) formal identification, and (5) a recommendation letter from the local council chairman where the applicant resides.

3.5.2 Success Microfinance Services Ltd - Non-Deposit Taking Microfinance Institution Serving Clientele of a Related Entity

Success Microfinance Services Ltd started as a credit department of an NGO—the Uganda Women's Effort to Save Orphans (UWESO), providing credit to UWESO orphans as a strategy to encourage them to engage in productive self-sustaining activity. Although UWESO was operating as an NGO or charity organization,

²⁰³ At the time of undertaking the research, FAULU was operating as a non-deposit microfinance institution. It has since changed its name to Opportunity Uganda and registered as a tier 2 Credit Institution.

the credit department provided micro credit services on a commercial basis. Providing the service to UWESO orphans was not only a means of economically empowering the orphans, but prior knowledge of the orphans made it easier to screen and monitor them. However, in 2004, Success Microfinance was incorporated as a separate entity providing credit to a much broader clientele. As of March 2008, it had 12 branches spread across the country, a loan portfolio of Ugshs. 1.2 billion and over 6000 clients, 80% of whom were women. Success Microfinance offers various loan products on an individual and a group guarantee basis.

Group guarantee loans are made available to either solidarity groups of five to 15 members or formally registered associations. An association is required to produce evidence of registration, collateral, banking records, and the particulars of its members, including the names of the chairperson, treasurer, and secretary. The association, as an entity, is responsible for repayment of the loan and may use the loan for corporate association activity or for onward lending to the members; the association determines the criteria for onward lending, including the repayment period and interest charged. This method may help individual members of the association to gain access to credit that they would otherwise not be able to obtain. However, while the association may have adequate information about its members, it is not always easy to ensure loan repayment or to guard against group disintegration. Additionally, the various stages of loan transmission (from the lender to the association, and ultimately to the members of the association) may make credit more expensive and repayment periods shorter. This is because administrative costs may increase the cost of credit. Also, for the association to be able to repay the loan, it has to lend to its members for a shorter period than the lender's repayment period.

Solidarity groups comprise of self-selected five to 15 members who undergo training and appraisal for two to four weeks prior to obtaining a loan. The first week is for training and providing information about loans and requirements for borrowing. In the second week, group members select leaders (a chairperson, secretary, and treasurer) and visit each other's businesses to appraise and verify the information provided by each member of the group. In the third week, each member of the group individually applies for a loan and is eligible to borrow differing amounts. The loans are disbursed in the fourth week. For subsequent borrowings, the period between applying and disbursing the loan is significantly reduced, depending on the past performance of the individual borrower and of the group.

Liability within the solidarity groups is at three levels beginning with the individual borrower, then the members of the core group of five, and, ultimately, the members of the larger group of 15. The average loan amount for solidarity groups is Ugshs. 300,000 for which a borrower is required to have prior savings of 20%. Once the loan is disbursed, after a two week grace period, the borrower is required to pay Ugshs. 18,800 per week for 18 weeks.

To minimize the risk of default, the appraisal of loan applicants includes screening for multiple borrowers, and verification of applicant's particulars, including their character and nature of business. In addition, group cohesion is fostered through regular meetings and intensive peer monitoring. Administratively, loan officers overseeing particular portfolios are frequently rotated to avoid complacency about monitoring.

Individual loan applicants are eligible to borrow between Ugshs. 1–3 million initially, repayable in six months at an interest rate of 3% per month. They are then eligible to borrow more money for longer periods (18 to 24 months) for successive borrowings. The requirements for individual loans include collateral or chattels, proof of ownership of a business, banking history, valid identification, payment of a loan processing fee (2% of the loan amount), and a loan insurance fee of 1% of the loan value. The borrower is also required to provide post dated checks covering the due dates of the installment payments for the entire duration of the loan.

3.5.3 Uganda Gatsby Microfinance Ltd - a Member Organization Microfinance Institution

Uganda Gatsby Microfinance Ltd. started operations in 2006. Before converting into a fully fledged microfinance institution, it was a credit department of the Uganda Gatsby Trust, – a member organization of small scale enterprises. It provides credit facilities only to businesses that are members of the Trust, and, as of March 2008, it had about 175 active borrowers. The Trust has 21 clubs in various districts in Uganda. Members of the Trust are required to pay a subscription fee, attend regular trainings, and receive assistance on business management activities, such as record keeping and preparation of business plans.

The credit facilities include asset acquisition loans and working capital finance. First time borrowers are eligible to borrow between Ugshs. one to three million

(\$500 to 1,500) repayable in 12 months, second time up to Ugshs. 6 million repayable in 18 months, third time, between Ugshs. 10 to 15 million repayable in 24 months. The interest charged on the loans is 30% per annum. The requirements for obtaining a loan include: membership in the Uganda Gatsby Trust for two to three months prior to applying for the loan, collateral with value exceeding the value of the loan, payment of a loan insurance fee, ownership of a value adding business, and a guarantor who is a member of the Trust.

Unlike the clientele of Success Microfinance who are largely engaged in informal sector small business activity that generates income to empower them economically, the clientele of Uganda Gatsby Microfinance are small scale businesses engaged in “value addition” or some form of processing activity, such as processing fruit into packaged juice or wine. The businesses are therefore, not the kind that would ordinarily be classified as micro enterprises. Providing credit to their own members is not only a service to those who would not be able to easily access credit elsewhere, but also is a risk mitigation tool. Membership provides a basis for a relationship between the lender and the borrower, and business skills training improves the borrower’s capacity to manage the business, thereby reducing mismanagement related risk. This practice also makes it easier for the lender to monitor the borrower and to obtain information from his or her peers.

3.5.4 Masaka Microfinance Development Co-operative -HYBRID MFI/SACCO

Masaka Microfinance Development Co-operative started in 1999 and provides commercial and consumer loans that are extended to its members either individually or in groups. Individual borrowers are usually located in urban areas, and group borrowers tend to be located in rural areas. The loans range from Ugshs. 100,000 to 5 million, repayable within 12 months, at an interest rate of 2.5% per month, except for agriculture loans, which are repayable in 18 months, at an interest of 2% per month. The average loan recovery rate is 95%, but it may vary depending on the performance of agriculture loans.

To obtain a loan, an applicant must: be a member, have an ongoing business, have savings and collateral worth at least twice the value of the loan, operate a checking account with the institution for at least a month, and have a guarantor who must also be a member. The period between applying and receiving a loan is two to four weeks for new clients, and one to two weeks for previous borrowers.

with a good track record. During the appraisal process, loan officers visit the loan applicant's business premises, verify collateral, and gather "soft" information about the loan applicant.

Masaka Microfinance Development Co-operative is a hybrid financial institution which operates as a non-deposit microfinance institution that provides credit to the public, and also operates as a savings and credit cooperative that mobilizes deposits from its members, who are also eligible to access credit depending on the amount of their savings.

3.5.5 Panyimur Savings and Credit Cooperative-SACCO

Panyimur SACCO was established in 2003 and operates in an area of north-western Uganda where agriculture and fishing are the main economic activities. Therefore, its credit facilities have been designed to support these activities and include small business loans, agricultural loans, and consumer loans. Loans range from Ugshs. 500,000 to 5,000,000, repayable in four to eight months, at 3% per month, except for agriculture loans whose repayment period is four to 12 months and interest of 2.8% per month, charged on declining balance.

Credit can be obtained either individually or in a group. For individual loans, the borrower must have collateral, while for group loans, the group guarantee is a substitute for collateral. The majority of loans are group guarantee loans. Due to the informal nature of business in this part of Uganda, screening borrowers involves obtaining information about loan applicants from informal sources such as business associates, customers and local leaders. The loan recovery rate is 96% which is attributed to the efficient screening and intensive monitoring of borrowers and the incentive of contingent credit (disbursement of small amounts repayable in short periods with the option for the borrower to access more money).

3.5.6 Kakuuto Small Business Development Cooperative Savings and Credit Society – Rural- Based SACCO

This SACCO is located in Rakai in South-Central Uganda and started operations in 2001. It provides business and consumer loans to its members, as well as agriculture loans provided the borrower has another source of income that is not primarily agriculture. The loans range from Ugshs. 100,000 to 500,000 and are lent either on an individual or a group basis. The loan repayment period is up to six months, and

interest is charged at 3% per month. The requirements for obtaining a loan include: ownership of a business, membership in the SACCO, collateral, prior savings, a guarantor who also must be a member, valid identification, and a recommendation from the local council chairman of the area where the loan applicant resides.

The loan recovery rate of 95% is attributed to effective screening prior to disbursement. In the event of default, the SACCO's recovery mechanisms include requiring guarantors to pay a borrower's outstanding loan, using local leaders to persuade a borrower to repay the loan, and suspending loan disbursement to a defaulter's community in order to attract social pressure.

3.5.7 Naguru Savings and Credit Cooperative - Urban Based SACCO

Naguru SACCO is an urban based institution located in Kampala. It started in 2004, and, as of March 2008, had 295 members. As a member based organization, all borrowers must be members and must pay Ugshs. 5,000 and buy at least one share valued at Ugshs. 20,000. Membership is not restricted on the basis of economic activity or geographical location. Therefore, unlike other financial institutions that provide services to clients within a specific radius as a measure of easy identification and monitoring, Naguru SACCO has customers from any location within the city. About 85% of the members are women engaged in small business retail activity and they largely borrow to finance working capital.

The SACCO has a chairperson, one manager and six loan officers. All, except the manager, are part-time employees. The governance structure is unclear, and although it operates as a member owned, managed, and controlled organization, the SACCO has never held an annual general meeting. The institution's affairs are directed and controlled by the Chairperson, who is also its founder. Appraisal and monitoring is done by loan officers. Although the SACCO has a loan repayment rate of 95%, a large proportion of its borrowers fail to adhere to repayment schedules. The close proximity of its management to the local political establishment deters delinquency and facilitates using the political machinery to recover from defaulters.

Naguru SACCO primarily lends small business loans to its members that range from Ugshs. 150,000 to 2,000,000, repayable in four to 12 months, at an interest rate of 2.5% per month. As of March 2008, the loan portfolio was at Ugshs. 70 million, with forced savings at Ugshs. 15 million. Loanable funds are

internally generated from membership fees and members savings. To obtain a loan, the applicant must be: a member, have a letter of recommendation from the local council chairman of her residence area, have at least one guarantor, save 20% of the loan amount required, attend weekly meetings, and save Ugshs. 2,000 every month.

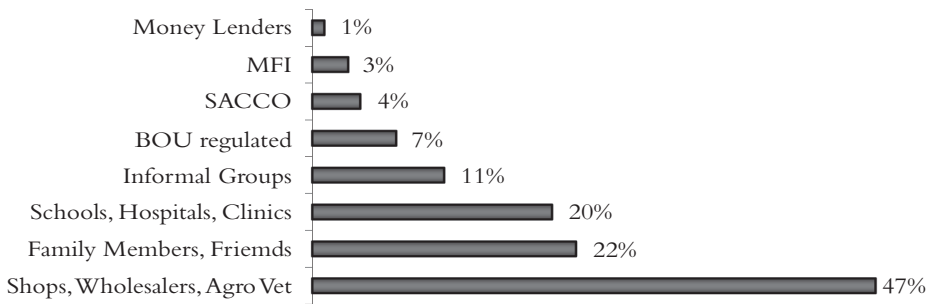
Although SACCOs are registered with the Registrar of Cooperatives under the Cooperatives Societies Act, it is not easy to establish how many SACCOs are currently active and operational. Anecdotal evidence suggests that there are more SACCOs than MFIs in Uganda. The majority are based in rural areas and have been set up recently in response to government programs designed to provide financial support to the economically active poor. Their method of operation – providing financial services to their own members and serving a particular geographical location – makes it easier to screen borrowers, hence minimizing risks associated with informational inefficiencies in the market. However, evidence indicates that due to lack of robust regulation, many SACCOs operate as money lenders or microfinance institutions. SACCO's loanable funds are generated from internally mobilized funds, which include savings and membership fees, government and grant credit extended to them for onward lending through the Microfinance Support Center and Post Bank (U) Ltd. The governance and management of SACCOs in Uganda is generally weak because of inadequate regulation, lack of skills, and poor record keeping. These deficiencies will severely limit their financial intermediation role.

3.6 INFORMAL FINANCIAL INSTITUTIONS

The majority of Ugandans are not served by any of the described formal and semi-formal financial institutions. Formal financial institutions are concentrated in Kampala and urban areas; therefore, distance and geographical location are major access barriers to accessing formal financial institutions. Some studies have shown that informal financial institutions play a greater intermediation role than formal and semi-formal institutions. For example, the 2007 FINSCOPE study showed that 33% of Ugandans claimed to be borrowing, of whom 54% obtained credit from informal sources that are not financial institutions, such as family members, friends, and shops, 11% reported borrowing from informal financial groups, and 12% indicated they were borrowing from formal and semi-formal financial institutions.²⁰⁴

204 FINSCOPE, *supra* note 17, at 28.

Figure 2: Where Ugandan’s Borrow from (2006)



Source: FinScope, Uganda: Results of a National Survey on Access to Financial Services in Uganda,28 (August 2007)

A 2009 study revealed that generally the most common sources used by those who are currently borrowing are institutions providing goods or services on credit i.e. shops, clinics etc (60%). This is followed by those borrowing from friends/family (33%) and informal financial groups (24%). Among the banks, it’s the commercial banks (7%) that are mostly used. Borrowing from Credit Institutions, Microfinance Deposit Taking Institutions, Microfinance Institutions and SACCOs stood at 1%, 2% and 2% respectively. Other informal financial sources such as services from schools or clinics are obtained on credit.²⁰⁵

Table 6: Sources of Borrowing by Gender and Setting (2006)

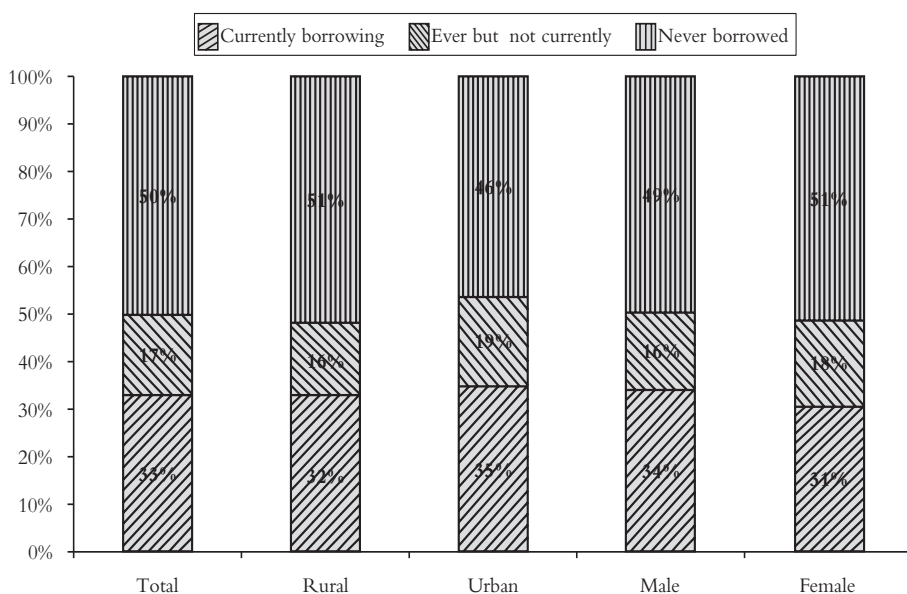
All currently borrowing	Rural	Urban	Male	Female
Weighted base	712	294	500	506
	3,175,953%	1,142,620%	2,137,300%	2,181,273%
Shops, wholesalers, Agro Vet	47	48	47	46
Family members/Friends	21	23	24	20
Schools/hospitals/Clinics	20	19	19	21
Informal Groups	12	9	11	11
BOU regulated	7	8	10	4
SACCO	4	3	6	2
MFI	4	1	3	4
Money Lenders	1	2	2	1

205 FINSCOPE UGANDA, Results of a National Survey on Demand, Usage and Access to Financial Services in Uganda, 2009, p 45-46.

Source: FinScope, Uganda: Results of a National Survey on Access to Financial Services in Uganda, 28 (August 2007)

In 2009, access and to and use of Bank of Uganda regulated institutions was high among the male (5%) and urban (6%) populations while informal sources are most commonly used by females (32%) and rural (33%) areas.²⁰⁶

Table 7: Ugandan's Borrowing Status (2006)



Source: FinScope, Uganda: Results of a National Survey on Access to Financial Services in Uganda, 28 (August 2007)

The 2009 statistics show an increase in the above trends with 45% of males reported borrowing and 44% females. In terms of location, 44% of borrowers are rural areas compared to 43%.²⁰⁷

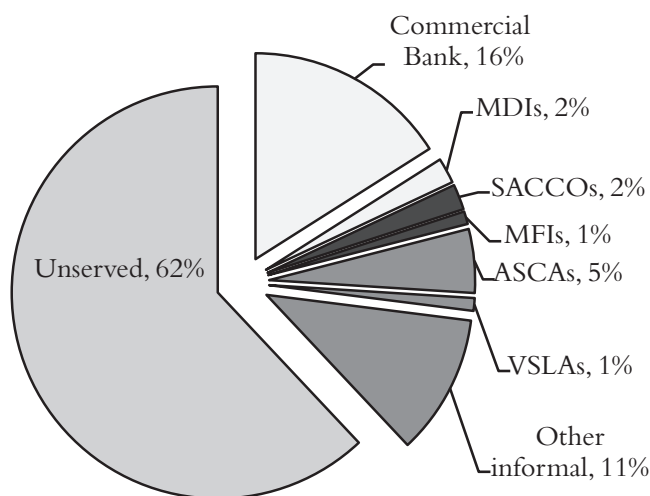
The above borrowing trends are also reflected in the analysis of access to financial services. Access to financial services is still a major constraint for the majority of households in Uganda. Although the 2009 statistics indicate that 70% of Ugandans aged 16 years and above have access to financial services, 42% of those are served

206 FINSOCPE, supra note 205 at 43-44.

207 FINSOCPE, supra, note 205 at 43-44.

by informal financial institutions, while formal financial access for adults in 28%, with 21% of adult Ugandans aged 16 years and above reported to be banked, while 7% have access through MFIs, SACCOs and insurance.²⁰⁸ Compared to 2006, they were only 38% of Ugandans using financial institutions of any type, and the majority of the population (62%) had no access at all. See the figure below on use of financial services.

Figure 3: Use of Financial Institutions in Uganda (2006)



Source: FinScope, Uganda: Results of a National Survey on Access to Financial Services in Uganda, 28 (August 2007)

In terms of financial access by gender and location, the 2009 data show that more men (31%) than women (26%) are formally served and more males (24%) than females (17%) are banked. A slightly higher proportion of females (8%) than males (7%) used other formal financial institutions. Thirty one percent of the females responded reported being financial excluded.²⁰⁹

Regarding location, usage of banks is higher in the urban (38%) than in the rural areas (17%). Similarly higher proportions of people in the urban (9%) than in the rural areas (7%) use other formal financial institutions that are not banks. However, the rural population (47%) use more informal financial services than those in the urban areas (28%).²¹⁰

208 FINSOCPE, *supra* note 205 at 28–30.

209 FINSOCPE, *supra*, note 205 at 29.

210 FINSOCPE, *supra*, note 205 at 29.

Table 8: Financial Access by Location and Gender (2006)

No. of Respondents	Total	Rural	Urban	Male	Female
	2,958	2,101	858	1,417	1,542
Weighted base	13,173,921	9,897,817	3,276,104	6,231,148	6,942,772
	%	%	%	%	%
Unserved	62	65	52	58	66
Banks	16	12	28	21	11
Financially Informal - Minus ASCAs	11	12	6	11	10
ASCAs	5	5	6	4	6
MDI	2	2	3	1	2
SACCO	2	2	2	3	2
MFI	1	1	1	1	1
VSLA	1	1	1	1	1
CI	0	0	1	0	0

Source: FinScope, Uganda: Results of a National Survey on Access to Financial Services in Uganda, 28 (August 2007)

The trends shown by this data are not unique to Uganda. Other studies have indicated similar trends in other developing countries. For example, a World Bank study of access to and use of banking services across countries showed that “banking sector outreach varies across countries. Ethiopia has less than one branch per 100,000 people, while Spain has 96. In Albania, there are 4 loans per 1,000 people and the average loan size is 15 times per capita GDP, while in Poland there are 774 loans per 1,000 people, and the average loan size is one-third of per capita GDP.”²¹¹ Limited outreach not only negatively impacts use of financial services, but also increases financing obstacles for firms.²¹² The variations in outreach are attributed to several factors, including differences in: the levels of financial development, population density, quality of governance, contract enforcement, economic freedom, the extent of Government control and ownership of financial institutions, quality of infrastructure, control of bank activities, and availability of credit information sharing mechanisms.²¹³

211 Thorsten Beck, Asli Demirgür-Kunt & Maria Soledad Martinez Peria, *Reaching Out: Access to and Use of Banking Services Across Countries*, 85 Journal of Financial Economics 234, 236 (2007).

212 Id. at 259.

213 Id. at 248-52.

3.7 FACTORS CONTRIBUTING TO THE COSTS OF PROVIDING CREDIT

Micro credit lenders in Uganda, like those in any other low income country, are faced with circumstances that impose additional costs of providing credit. Chapter 6 discusses the measures adopted to mitigate the risks of those costs. However, below I highlight some of the factors that affect the cost of providing credit in a market like Uganda's.

3.7.1 Lack of creditor information

"I belong to a group loan scheme at PRIDE Microfinance Nakawa branch but I needed more money so I joined another group at a different branch and PRIDE has never discovered this." **Grace, proprietor of a hair dressing business.**

"I started borrowing money from PRIDE Microfinance in 2002 and have now graduated from the group loan arrangement to an individual borrower because I now have some assets I can pledge as collateral. However, I also borrow from Uganda Microfinance Ltd. as a member of a group and PRIDE does not know this." **Silvia, proprietor of a transport business.**

Lack of creditor information is perhaps the greatest challenge that lenders face. These excerpts from interviews with micro enterprises proprietors demonstrate that not only are creditors unable to obtain information about loan applicants' credit history, but that their clients may be multiple borrowers within the same institution without its knowledge. Lack of a credit reference bureau, lack of a uniform national identification system and inadequate infrastructure are some of the factors that make obtaining information about loan applicants so difficult.

Commercial banks use more formal creditor verification means such as requiring incorporation documentation, bank statements, audited accounts, and directors' resolutions. Banks also obtain information by conducting searches in the company's registry. While the majority of commercial bank clients operate within the formal system, formal creditor verification is far more difficult when loan applicants cannot meet most formal requirements, as is the case with the majority of micro enterprises.

Some lenders have attempted to devise a reliable system to overcome this challenge. An example is relationship building, whereby a potential loan applicant is required to have an existing relationship with the financial institution, either as a

member or a customer operating a checking account or as a loan applicant trained by the institution. Other creditor verification mechanisms include: membership in a trade association,²¹⁴ peer selection for group guarantee loans, membership requirements, guarantors who are members of the institution, a letter of recommendation from the local council where the applicant resides, and geographical operational restrictions.²¹⁵ Some financial institutions co-operate informally and share information about loan applicants. A credit reference bureau was set up in 2007, but it is still too early to assess whether it will resolve the problem of information asymmetry.

3.7.2 Problems with property registration and verification of ownership

“We accept land purchase agreements as evidence of ownership where one does not have certificate of title”. **Rushere Savings and Credit Cooperative.**

“We rely on the local council chairman of the area where the loan applicant resides to verify residence, land and property ownership” **Ibanda Cooperative Savings and Credit Society.**

“In cases where we take chattels as collateral, our loan officer visits the premises of the loan applicant and takes a photograph of the client standing next to the chattels.” **PRIDE MDI.**

The majority of lending institutions I interviewed indicated that in appraising a loan application, they were more concerned about the borrower’s cash flow than about collateral. This does not mean that collateral is not important. It provides a fallback position in the event of default. Therefore, it is critical that the creditor ascertain ownership of the collateral ex-ante. However, determining ownership of collateral is not always possible in jurisdictions where property registration and ownership verification at registries are slow and costly. In Uganda, the most common form of collateral is land, and the lack of an efficient land registry makes verifying ownership and registration of interests in land, difficult, costly and time consuming. Chattels can also be used as collateral, but the majority are not registered.

214 These include Uganda Manufacturers’ Association, Uganda Women Entrepreneurs Association, Uganda Small Scale Industries Association, Kampala City Traders Association and Private Sector Foundation. These associations provide various services to their members, including letters of recommendation for loan applications. In some cases, they have relationships with financial institutions that enable their members to access financial services.

215 Most microfinance institutions serve clients within their geographical location. This makes it easy to obtain information about new loan applicants as well as to monitor creditors as well as apply social pressure to recover in case of default.

In addition, although Uganda has a system of registering and verifying property ownership, a large section of the population holds untitled property. Some land tenure systems, such as the customary land tenure system, make it difficult to hold individual land titles because land is communally owned. The 2006 Doing Business in Africa survey shows that in Uganda, on average, 44 days are required to register property, at a cost of close to 5.1% of its value.²¹⁶ Uganda compared favorably to other African countries. In Togo, Ghana, and Rwanda, it takes over 360 days to register property, and in Mali and Nigeria, the cost of registering property is over 20% of its value.²¹⁷ However, the high transaction costs of registering property, and the large proportion of unregistered property, limits the financing opportunities for businesses.

Micro credit institutions have devised means of overcoming challenges associated with property registration and verification. These measures include use of collateral substitutes such as forced savings, insurance, and group guarantee arrangements. However, if collateral is used, alternative forms of ownership include using purchase agreements, peer/group verification, or area local leaders where the applicant resides.

3.7.3 A Weak Environment for Contract Enforcement

A weak environment for contract enforcement was not considered a serious challenge by most financial institutions, but they did cite delays and high costs of enforcement in courts of law. Corruption was also a problem when the value of the loan is small, and the contract has to be enforced in lower courts, particularly magistrates' courts. Corruption is perceived as more prevalent in magistrates' courts than in the higher courts (the High Court, Court of Appeal and Supreme Court) where the problem appears to be more one of delays due to the backlog of cases.

Most financial institutions, including commercial banks and microfinance institutions, use private enforcement more frequently than enforcement through the courts because private enforcement is cheaper and faster. Therefore, sale by private treaty (the option to realize collateral without going to court) is a standard clause in lending contracts. In addition, the lending methods used by micro lenders rely on enforcement tools other than judicial enforcement, such as joint liability, peer pressure, and social collateral in group lending. Threats, negative publicity,

²¹⁶ The World Bank, *Doing Business in 2006: Sub-Saharan Africa Region*, at 15. (Available at <http://www.doingbusiness.org/>).

²¹⁷ *Id.* at 15.

and intimidation of defaulters are all methods used to force compliance with contractual obligations. In addition, the incentive of contingent credit is used to repay their loans and remain eligible for future credit.

3.7.4 Lack of Regulation

Regulation per se does not lead to the efficient operation of credit markets and can, in fact, lead to some distortions, particularly when the burden of regulation exceeds the benefits. However, lack of or inadequate regulation can also produce some undesirable consequences. As indicated earlier, Uganda's financial sector is classified into four tiers. Tiers 1–3 comprises of commercial banks, credit institutions and micro deposit taking institutions. These are formally incorporated and subject to prudential regulation by the central bank. Tier 4 financial institutions include microfinance institutions, SACCOs, ASCAs, and VSLAs which may be established and registered either as a company, Non-Governmental Organization, a cooperative society, or an association. However, other than registration, they are not regulated. This lack of regulation raises concerns about the institution's governance structures, methods of operation, safety of client money, and client protection from exploitation.

One observable outcome of inadequate regulation of micro credit lenders in Uganda is that the manner in which they are set up and operate their business is often misleading. For example, several micro credit providers are established as savings and credit cooperatives, but operate as microfinance institutions. The former are essentially supposed to be owned and managed by their members. They are permitted to mobilize deposits from, provide credit and other services to their members. Microfinance institutions, on the other hand, operate as non-member based lending businesses and are not permitted to take deposits (except for MDIs). Several savings and credit cooperatives lend and take deposits from non-members, and non-deposit taking microfinance institutions take deposits from their clients or impose some form of membership requirement on loan applicants.

The issue of regulating Tier 4 institutions has been the subject of policy debate, but a regulatory framework has yet to be put in place. As an interim measure, some Tier 4 institutions are members of the Association of Microfinance Institutions in which they voluntarily subject themselves to the codes of conduct set by the association, such as the Consumer Code of Practice. However, compliance is voluntary, and the association has no means of enforcing the codes. Therefore, cases of client exploitation and abuse are not uncommon. Some people have reported losing money

to micro lenders that demand membership payments and loan application fees prior to obtaining a loan but never disburse the funds. Some lenders take advantage of the ignorance of some clients and fail to disclose how loan repayments are structured, while others continue charging interest and making deductions from borrowers long after a loan has been repaid.²¹⁸ Other practices, such as using extra legal means to enforce repayment of a loan, do not necessarily result from inadequate regulation, but from a weak environment for the contracts enforcement.

3.7.5 Nature of Business Enterprises.

“Initial assessment of small businesses is difficult because they neither register their properties nor document their transactions,” Loan **officer at Centenary Bank**

A key characteristic of micro enterprises, as well as of some small and medium enterprises, is that they operate in the informal sector, making assessing their business for purposes of extending credit difficult. A loan officer who visits business premises, often must estimate the value of the stock, sales and revenues, depending on what the officer observes or on the location of the business, or on the performance of similar business that the officer has dealt with previously. This assessment may be subjective. In addition, since business assets are usually not formally registered, a loan officer will either have to heavily discount them, which affects the amount the business is eligible to borrow, or to frequently monitor the business, which increases the per unit cost of lending and ultimately translates into higher costs of credit.

A common characteristic of small business is the lack of a clear distinction between the business as an entity and its owner, irrespective of whether the enterprise is formally incorporated or not. Lenders are always mindful of this problem when dealing with such enterprises. The issue is two-fold. First, the assessment of the owner is critical for the enterprise to access credit. Second, the fusion of roles raises concerns about the enterprise's long-term sustainability, making creditors unwilling to extend long-term credit.

“Some of the money I borrowed, I used to purchase personal items.” **Aisha Namugerwa, proprietor of Grace Beauty Salon.**

“We have less female defaulters than males because for a woman, if her business fails, she will repay the loan from other sources such as family and friends.” **Officer at PRIDE MDI**

218 For example it was reported that Luweero District had suspended the operations of Bayport Financial Services due to fraudulent practices, such as prolonged deductions from borrowers' salaries even after they had completed their loan obligations. See Luweero District Stops Bayport Financial Services, The New Vision, 11 December, 2008. (<http://www.newvision.co.ug/D/8/13/664232>) (Accessed 12/23/2008).

Use of loan proceeds for personal purposes may compromise a borrower's ability to repay a loan. Several respondents admitted that while they used part of the loan for personal purposes, the business was still able to generate enough revenues to pay back the loan. If the business failed, they would borrow from friends and family to repay the loan. Some indicated that defaulting on a loan was likely in cases in which a borrower used the entire loan for personal purposes. Other problems that may lead to failure to repay were factors that might affect the performance of the business like theft of equipment or stock, a fire that damages the business premises, and an illness of the proprietor.

CHAPTER FOUR

4.0 MICRO CREDIT AND THE PROMISE OF MICROFINANCE: BRIDGING THE ACCESS TO CREDIT GAP

Chapter three demonstrated the dualism and stratification in Uganda's financial sector. The first tier financial institutions, primarily commercial banks, serve only a very small section of economic players who are largely within the formal sector. Efforts to broaden their outreach have concentrated on devising mechanisms of lending to small and medium enterprises through leasing, asset-based lending, and lending against receivables. Tiers 2 and 3 financial institutions provide credit to both informal and formal sector micro and small enterprises. However, their numbers are limited, leaving the bulk of the population to obtain credit either from microfinance lenders or from informal sources.

In this Chapter, I describe the history of micro credit in Uganda, and the attempt by microfinance to bridge the access to credit gap through increased outreach and product development. The last section analyzes selected "success stories" of micro enterprise finance.

4.1 THE HISTORY OF MICRO CREDIT IN UGANDA

Micro credit simply refers to providing financial services, particularly savings and credit to low income clients, and entails small loans, repeat borrowing of incremental loans, informal appraisal of loan applicants and use of collateral substitutes, such as forced savings and group lending. Over the years, micro credit has evolved into microfinance, which is a much broader concept that includes providing money transfer services, savings mobilization, micro insurance, financial literacy, enterprise development, and social intermediation.²¹⁹

The United Nations declared 2005 as the year of micro credit, in recognition of the contribution of micro credit programs to the eradication of poverty, as well as social and human development.²²⁰ However, micro credit programs all over the world, including Uganda, have a much longer history than 2005, or the last decade, when microfinance came to the fore front of major development programs. The concept is more than a century old and may have its roots in the 19th century German credit cooperatives that provided credit to poor people in small rural communities.²²¹

219 Joana Ledgerwood, *Microfinance Handbook: An Institutional and Financial Perspective 1* (1998).

220 G.A. Res. 53/197, 1 U.N Doc.A/RES/53/197 (Dec. 15, 1998).

221 Joana Ledgerwood, *supra*, note 219, at 2.

In almost all countries, micro credit programs have existed in various forms including government credit programs, NGO credit activities, informal savings and credit programs, and savings and credit cooperatives. Although micro credit programs continue to evolve in terms of institutional structure, product development, and methods of lending, the majority follow the Grameen Bank model. The Grameen Bank was started by Muhammad Yunus in 1976 as a research project exploring a feasible credit delivery mechanism for the poor.²²² Other institutions that have helped spur the “microfinance revolution” are ACCION International in Latin America and Uniao de Bancos Brasileiros (UNIBANCO) of Brazil.

In Uganda, micro credit has its roots in informal credit mobilization schemes, and state directed credit programs, as well as formal and semi-formal micro credit institutions. The former include informal sector institutions such as Rotating Savings and Credit Associations (ROSCA's), Village Savings and Loan Associations (VSLA's), and Accumulating Savings and Credit Associations (ASCA's). State directed credit programs have historically been designed to eradicate poverty through subsidized credit programs such as the 1961 Co-operative Credit Scheme, the 1964 Progressive Farmers Loan Scheme, the 1988 Rural Farmers Scheme, the 1994 Poverty Alleviation Project, and the 1995 *Entandikwa* (seed capital) Credit Scheme. The projects were all initiated by the government and credit delivered directly through government agencies. Save for the Poverty Alleviation Project, these programs performed poorly for various reasons, including poor design, political interference, lack of qualified staff, delays in loan disbursement, and poor supervision. However, this method of credit delivery appears to have had an inherent weakness. Some commentators have argued that direct state intervention in credit markets is inefficient.²²³

Most micro lenders in Uganda are Tier 4 financial institutions, which are not permitted to intermediate deposits from the public (other than from their own members, or as collateral for savings). They are established in various forms including as companies, non-governmental organizations, savings and credit cooperatives. Apart from MDIs which are supervised by the Central Bank, Tier 4 micro lenders are not subject to any form of prudential regulation. Finding an appropriate regulatory framework for Tier 4 microfinance institutions is currently the subject of intense policy discussions.

222 A Short History of Grameen Bank. <http://www.grameen-info.org>. (Accessed 8/04/2008).

223 William Muhumuza, Credit and Reduction of Poverty in Uganda: Structural Adjustment Reforms in Context 163 (2007).

Since 1990, the microfinance sector in Uganda has demonstrated remarkable growth in outreach and provision of financial services, particularly to the “economically active poor”. Microfinance institutions have broader outreach than formal financial institutions. The rapid growth of microfinance in Uganda can be attributed to several factors, including the use of innovative lending methods that have enabled those who were unable to obtain credit to do so. Other factors that may have contributed to the rapid growth of microfinance are: increased demand for credit and financial services that is not matched by supply; the success of earlier programs in Latin America and Bangladesh that has spurred similar programs, particularly in Africa; increased global attention to the economically active poor who do not have access to financial services; and donor support to the microfinance sector.

Although micro credit is not a new concept in Uganda, the majority of currently active micro lenders have only been recently established (between 2002 and 2007), while a few have been in existence for a slightly longer period, but not exceeding ten years. This phenomenon can be attributed to several factors including: (1) the gap created by the collapse of the Cooperative bank in 1998, which was a major source of micro credit; (2) the privatization and liberalization of the banking sector, which introduced new players, most of whom are foreign and inaccessible to the majority of the economic players; (3) political stability that has led to increased economic activity and, therefore, demand for credit;²²⁴ (4) government programs that seek to channel credit through microfinance institutions; and (5) generally the global microfinance movement.

Following the poor performance of several direct state credit programs, the government consulted with various stakeholders on how to efficiently improve access to credit, particularly for those that are unable to access commercial bank loans. Factors that inhibit access to credit include: limited geographical outreach of financial institutions due to poor infrastructure; high transaction costs; failure of the mainstream financial institutions to design suitable products for the economically active poor who require small loans and yet have a limited or no substantial asset base; rigorous and costly loan processing procedures that exclude the majority of the population; and widespread use of collateral lending in an environment where land ownership is not streamlined and some borrowers, such as women, do not own property that can be used as collateral.

The government, with the support of donors, has promoted the development

224 Save for northern Uganda, there has not been a major war that has disrupted economic activity in Uganda since 1986.

of the microfinance sector with the objective of improving the outreach of financial institutions and access to micro credit. In 2003, the Ministry of Finance, in consultation with various stakeholders, developed a strategic plan for expanding the outreach and capacity of sustainable microfinance institutions in Uganda. The key aspects of the plan were to work towards achieving a 25% client growth per year, increasing outreach to 1.3 million clients by 2006, and increasing rural penetration of microfinance institutions. In order to achieve these targets, the strategic plan provided for building the institutional capacity of microfinance institutions, developing new products and delivery mechanisms, creating a policy and regulatory framework for rural microfinance, and government divestiture from direct microcredit delivery. It is increasingly becoming clear that the government's role is to create an enabling environment for credit markets to operate, rather than direct delivery of credit.

Microfinance institutions in Uganda face several challenges, including lack of adequate skills, poor infrastructure, poor corporate governance, inadequate regulation and supervision, and limited financial intermediation capacity. However, there are ongoing efforts to resolve these problems including donor support for capacity building, infrastructure development, product design, and credit supply.²²⁵

The government of Uganda is increasingly seeking to use microfinance institutions, particularly Savings and Credit Cooperatives as avenues for state credit programs. The Poverty Alleviation Project (PAP) was initiated in 1994, by the government in partnership with the Africa Development Bank as an initiative to eradicate poverty, targeting the rural poor. Credit was delivered directly to groups and individuals, and over the project's lifespan (1994–98), there was evidence of good recovery rates, particularly with formal and organized groups. A follow-on rural microfinance support project was initiated with three components:

- (1) Credit and savings. The idea was to channel credit through microfinance institutions at quasi-market interest rates determined by looking at the six month aggregate of treasury bill rates, commercial bank lending rates, and inter-bank lending rates. The aggregate rate would then be applied for the next six months. By receiving wholesale credit at quasi-market interest rates, microfinance institutions were expected to charge lower rates of interest to their clients and reduce the cost of credit and stimulate savings.

225 For example the financial sector deepening project supported by the UK's Department for International Development committed £7.1million over a period of five years from 2001, to strengthen the capacity of the microfinance sector in Uganda. See <http://www.fsdu.or.ug/about.htm>. Other donor agencies that have supported the microfinance sector are the Swedish International Development Agency and the German Technical Cooperation Agency (GTZ).

- (2) Capacity building. Using microfinance institutions to deliver credit must be sustainable and innovative. Therefore, institution building, training, infrastructure development, and information sharing are all necessary to improve the efficiency of service delivery. Capacity building and institutional development are critical because costs associated with the operational inefficiencies of microfinance institutions significantly contribute to the high interest rates they charge.
- (3) Project implementation. The Microfinance Support Center (MSC) was set up as a company, wholly owned by the government, to manage the project, as well as any other credit delivery projects. Currently, the MSC manages the North West Small Holder Agricultural Development Project, which was designed to extend credit to farmers in the West Nile region, as well as develop infrastructure such as roads. The MSC only manages the credit component of the project, amounting to USD 14 million. The MSC also manages the government SACCO fund, through which it channels wholesale credit to SACCOs. The main credit lines are: commercial loans disbursed at 13% per annum repayable in 2 years, agriculture loans disbursed at 9% per annum with a grace period of six to 12 months, and repayable in three to four years, and solar loans disbursed at 9% per annum. The MSC is also in the process of initiating asset acquisition loans and start-up loans for SACCOs.

Although microfinance institutions continue to face challenges in the areas of skills development, corporate governance, and credit supply, it is evident that, since the 1990s, they have attempted to fill the financial intermediation gap created by the collapse of the Cooperative bank and by the privatization of the Uganda Commercial Bank. These two financial institutions had broad outreach and had been extensively used by the government and by donor agencies to intermediate rural finance.

4.2 MICROFINANCE INSTITUTIONS: OUTREACH AND PRODUCT DEVELOPMENT

The Outreach of formal financial institutions and access to credit continue to present themselves as challenges to households and firms in developing countries. Overcoming barriers to outreach and access to credit is a slow and costly process. Therefore, firms in developing countries continue to face higher financing obstacles, which translate into higher growth and firm entry constraints and ultimately, constraints on economic growth. However, in the past decade, microfinance has emerged as a potential solution to the outreach and access to credit constraints, particularly for poor households and small businesses.

Current statistics on the number of microfinance institutions in Uganda are not available. The data that is available from two different studies is contradictory. A microfinance effectiveness review carried out in 2004 estimates that by the end of 2002, over 1,500 microfinance institutions were intermediating savings from over 930,000 clients.²²⁶ A census of microfinance institutions, conducted in 2006, found that there were 741 microfinance institutions with 1,064 outlets across the country.²²⁷ Most of the microfinance institutions operate within a localized geographical area and, except for a few that have two to three outlets, the majority have one outlet dedicated to serving a particular geographical location. For example, of the 82 microfinance institutions captured in the survey, 57 operate with a single outlet, while 22 have more than one outlet, usually between two and five. Only three institutions had more than ten but fewer than 30 outlets.

Microfinance institutions provide financial services, including credit to individuals and firms that would otherwise not be in a position to access the services provided by the mainstream financial institutions. They are able to do so using “innovative lending” mechanisms that minimize risks associated with information asymmetry and weak contract enforcement. The mechanisms include using collateral substitutes, lending small amounts, and requiring shorter, flexible repayment periods. Microfinance institutions are multiplying faster than commercial banks and are providing services in areas that commercial banks have traditionally regarded as unviable. The anecdotes and some of the evidence seems to suggest that these institutions have devised ways to provide appropriate financial services to those who were previously excluded, as well as to overcome the outreach and access barriers.

All microfinance institutions provide credit either on an individual basis or through group guarantee loans. Credit offerings include salary loans, consumer loans, medical emergency loans, agriculture loans, asset acquisition loans, business or commercial loans, and school fees loans. Some loans require collateral, while others do not. The range of loans, interest rate payable and repayment periods vary depending on the nature of the loan. Some loans are as low as Ugshs. 50,000, while the upper end is between Ugshs. 5-10 million. Except for agriculture and asset acquisition loans for which repayment periods may extend up to 24 months, most loans have a repayment period of three to 12 months. The interest rates for

226 Uganda Microfinance Sector Effectiveness Review, 4. CGAP Publication (October 2004) (http://www.cgap.org/gm/document-1.9.2166/clear_uganda_presen.pdf).

227 Luke Okumu, *supra* note 202.

agriculture and asset acquisition loans range between 2.5% and 2.8% per month, while on average, the interest rate on other loans is between 3 and 4% per month, and this be charged either as a flat rate or on a declining balance.

Because most microfinance clients are unsophisticated, loan repayments are usually structured into weekly or monthly installment payments. Therefore, while most clients do not know the interest rate payable on their loan, they are aware of the required installment payments and of any other payments, such as the upfront loan application fee, the loan insurance fee, and the compulsory savings. Below is a structure of installment payments for the minimum and maximum amounts that one is eligible to borrow from Naguru Savings and Credit Cooperative. Note that the installment payments vary depending on the duration of the loan.

Table 9: Structure of Payments for the Minimum and Maximum Loan Amounts at Naguru SACCO as of 2008

Amount (Ugshs.)	Monthly Installment Payment (varies depending on the amount borrowed and duration of the loan)	Total Amount Due (excluding weekly forced savings)
150,000	41,250 (4 months)	165,000
	28,740 (6 months)	172,500
	22,500 (8 months)	180,000
	18,750 (10 months)	187,500
2,000,000	550,000 (4 months)	2,200,000
	383,000 (6 months)	2,300,000
	300,000 (8 months)	2,400,000
	250,000 (10 months)	2,500,000

Table 10: Actual Loan Cycle of a Microfinance Client

1st loan obtained in 2002			
Payments and activities prior to loan disbursement			
1st week – Client orientation			
2nd week – Group formation			
3rd week – Visits to premises of group members, account opening, and payment of initial forced saving of Ugshs. 2,200			
4th week – Request loan application form and deposit savings of Ugshs. 2,200			
5th week – Submit loan application form and pay loan application and loan insurance fees of 2% and 1% of the value of the loan respectively			
6th week – Deposit savings of Ugshs. 2,200 and 1st loan is disbursed			
Amount (Ugshs.)	Repayment Period	Weekly Installments	Compulsory Weekly Deposit (Savings)
1 st Loan – 150,000	25 Weeks	6,900	2,200
2 nd Loan – 300,000	30 Weeks	11,800	2,200
3 rd Loan – 500,000	50 Weeks	15,500	2,200
4 th Loan – 800,000	50 Weeks	20,800	2,200
5 th Loan – 1,100,000	50 Weeks	28,600	2,200

The requirements for obtaining a micro loan vary depending on the nature of the loan, but generally they include: ownership of an existing business, payment of a loan application fee, attending training at the microfinance institution, a recommendation letter from the local council chairman of the area in which the applicant resides, identification documents, and opening a checking or savings account with the lender,²²⁸ as well as complying with applicable membership²²⁹ and savings requirements.²³⁰ In addition, most lenders require

228 The account requirement only applies to lenders that are allowed to intermediate deposits either from the public or from their own members, such as MDIs and savings and credit cooperatives. Other microfinance institutions simply require the borrower to make installment payments at designated bank accounts with other financial institutions.

229 Savings and Credit Cooperatives are member based organizations that collect deposits and lend to only their members. They have membership requirements including a membership fee that is usually very minimal, averaging Ugshs. 10,000. Some institutions either require a loan applicant to simply be a paid up member or to have been a member for a prescribed period of time, such as three months, in order to be eligible for a loan.

230 The requirement to have prior savings applies to both savings and credit societies and microfinance institutions. The amount of savings varies. Some lenders require a client to have saved for a minimum of three months or to save a minimum lump amount such as Ugshs. 10,000 or a percentage of the value of the loan, usually between 5% and 25%. In addition, borrowers may be required to make weekly forced savings that they can only withdraw upon successfully repaying the loan.

the applicant to have at least two guarantors who must be members of the institution from which the applicant seeks to obtain credit. This practice not only reduces the risk of default, but also serves as an ex-ante screening mechanism.

The time for processing a loan application varies from two to four weeks, and, in the case of subsequent borrowing, the time is significantly reduced, depending on the performance of the individual borrower and her group. The processing time for a first time loan applicant tends to be longer due to the appraisal process, the requirement to have accumulated savings, and the training requirements for new applicants.

4.3 MICRO CREDIT AND MICRO ENTERPRISE ACCESS TO CREDIT: ANECDOTES OF SMALL LOANS PRODUCING BIG CHANGES

The following cases below are some of the “success stories” of micro entrepreneurs who received awards from Citi Group, in conjunction with ACCION International and the Association of Microfinance Institutions of Uganda, recognizing their ability to grow and impact the communities around them. They are all clients of various microfinance institutions and SACCOs operating in Uganda.

Alice Mwagale, aged 31.

Ms. Mwagale is a resident of Fort Portal in western Uganda. She started out as a proprietor of a small business, selling agricultural produce, plastics, and second hand clothes. She obtained her first loan of Ugshs. 100,000 through group lending from HOFOKAM Microfinance in 1998, and subsequently went through 14 loan cycles with the same lender. Currently, her primary venture is a soft drinks retail business, but she has also been able to diversify into agriculture, transport, and real estate. Her monthly income from all her businesses is Ugshs. 57,633,350 and her business employs 11 people.

Margaret Ocika, aged 43.

Ms. Ocika is a resident of Nebbi District in north-western Uganda. She started her retail business of selling pancakes in 1991 with initial capital of Ugshs. 1,000 from which she earned a daily profit of Ugshs. 400. She saved Ugshs. 2500 in the profits from her business and used it as start-up capital for another business of brewing and selling local beer from which she earned a daily profit of Ugshs. 1,200.

She used the earnings from both businesses (Ugshs. 9000) to start a restaurant from which she earned Ugshs. 9000 daily. She joined an informal rotating savings group to which she was required to contribute Ugshs. 20,000 (weekly and received Ugshs. 200,000 which she invested in a fish retail business from which she earned Ugshs. 60,000 weekly. She was able to earn Ugshs. 1,000,000 from all her businesses, which she invested in a retail shop and agricultural produce business which earned her a monthly profit of Ugshs. 400,000.

In 2003, Ms. Ocika obtained a loan of Ugshs. 300,000 from PANYIMUR SACCO that was repayable in three months. She then obtained another loan of Ugshs. 800,000 which she used to purchase more stock for her businesses. This loan was followed by another of Ugshs. 1,000,000 with which she bought a motorbike and ventured into fish trading. She then obtained another loan of Ugshs. 2,000,000 that she used to purchase a milling machine, and then, with a combined loan of Ugshs. 11,000,000 from the SACCO and Centenary Bank, she ventured into the transport business by buying a heavy goods vehicle. She employs 24 people in her various businesses.

Ntale Sulaiman, aged 35

Mr. Sulaiman is a resident of Kyotera in Rakai district of south-central Uganda. His business activities are farming and processing agricultural produce. He acquired his first loan of Ugshs. 300,000 repayable in six months from Kakuuto Savings and Credit Co-operative. The loan was obtained on an individual basis and secured by unregistered land worth Ugshs. 3 million. He has undergone three loan cycles. He has diversified his business to include a plant nursery and an herbicide store. He employs 21 people, and the gross from all his business has grown to an annual turnover of Ugshs. 5 million.

These “success stories” have common underlying features:

- (1) The businesses were started as income generating and self-employment projects for their proprietors, and did not require any special skills or substantial start-up capital;
- (2) The role of informal finance, particularly in providing start-up capital; however, access to formal credit was a major factor in subsequent growth and diversification;
- (3) Microfinance provided an entry point to formal credit markets because the businesses and their proprietors had no prior banking history. Initial earnings and asset levels were insufficient to qualify them for commercial bank credit;
- (4) Credit was obtained from a micro lender that operated in the area where the busi-

nesses were located. This is an indicator of screening and monitoring tools used by lenders in markets with information asymmetry and moral hazard problems. Micro lenders use local knowledge and proximity to clients to informally gather information about them.

These above businesses have features that are common to micro enterprises in Uganda, which I discuss in detail in Chapter five. They also highlight the importance and limitations of informal credit. The critical role of informal credit is to provide start-up capital. However, the subsequent growth of these businesses is almost always associated with access to formal credit, which may explain why they are “success stories.” Other factors, such as entrepreneurial ability, may have contributed to the success of these businesses, but access to micro credit was certainly a significant factor.

Conclusion

Broadening access to credit by improving access to micro credit is not new in Uganda. Initially, the government was directly involved in credit delivery programs. However, a shift has occurred towards increased private sector participation in credit delivery. Over the last decade, Tier 4 financial institutions, particularly microfinance institutions and SACCOs, have increased rapidly hence broader outreach. In addition, micro credit lenders have designed products and methods of lending that make it possible to minimize information asymmetry and moral hazard. The above “success stories” demonstrate that access to formal credit has a positive impact on enterprise growth. Micro lenders have designed loans suited to the needs of their clients and sometimes to the economic activity of the area in which they operate. Examples include fishing loans in areas where fishing is the main economic activity, agricultural loans in predominantly agricultural areas, and motorcycle loans in areas where transporting people on motorcycles is lucrative business.

The loan recovery rates of the microfinance institutions and SACCOs range on average between 95 and 97%. These rates indicate that microfinance is viable. Additionally, the distribution of MFIs and SACCOS shows that they have achieved more market penetration than commercial banks. Therefore, although an access to credit remains problem, microfinance has attempted to bridge the access gap. In Chapter five, I discuss the nature of micro enterprises in Uganda and the determinants of their financing choices.

CHAPTER FIVE

5.0 MICRO ENTERPRISES IN UGANDA: DEFINING CHARACTERISTICS AND DETERMINANTS OF FINANCING DECISIONS

As indicated in the methodology section in Chapter 1, the survey covered a total of 602 micro enterprises. Below I present the findings on the nature of micro enterprises in Uganda, how they finance their businesses and the factors that influence their financing decisions.

5.1 MICRO ENTERPRISE CHARACTERISTICS

5.1.1 Business Incorporation

The majority of micro enterprises operate as informally established sole proprietorships. This finding is consistent with the literature on micro enterprises, particularly the fact that they operate in the informal sector. However, nearly all of the enterprises had some form of trading license issued by the local government of the area in which they operate. The license identifies the owner of the business and its location, and is renewable every financial year. Most respondents did not understand the concept of business incorporation and thought that having a trading license meant that they were incorporated.

Several factors can be attributed to the manner in which micro enterprises are established. First proprietors generally understand neither the concept of incorporation nor the financial and legal implications of establishing a business as a legal entity separate from its owner. Second, the majority of micro enterprises start as spontaneous business or economic opportunities, rather than as well-thought out business ventures, particularly businesses that operate by the road side, or in other strategic areas, such as telephone booths that operate along busy streets. The owners are primarily concerned with the economic opportunity that the business presents rather than with the formalities of establishing the business. Third, rule of law issues also explain the manner in which businesses generally are established and financed. Although a mechanism exists for incorporating businesses in Uganda, the process and the legal and regulatory burdens, associated with formalizing a business, create costs that, in most cases, far outweigh the benefits or even the economic opportunity created by the business. Commenting on the role of law

in determining the efficiency of the economic activities it regulates, De Soto argues that if laws impede or disrupt economic efficiency, they not only impose unnecessary costs of accessing and remaining in the formal system, but costs of operating informally as well.²³¹ The former include the time and cost of registering a business, taxes and complying with bureaucratic procedures.²³² On the other hand, the costs of informality include costs of avoiding penalties, evading taxes and labor laws and costs that result from absence of good law such as not having property rights, inability to use the contract system, and inefficiencies associated with extra contractual law.²³³

Businesses in Uganda are registered by the Registrar of Companies under the Company's Act. The office of the Registrar of Companies is located in Kampala and this imposes a burden on businesses that operate in other parts of the country that would wish to be registered. In addition, the following fees are required to incorporate a company: a name search and reservation fee of Ugshs. 25,000, stamp duty of 0.5% of the value of the share capital, memorandum and articles of association registration fee of Ugshs. 35,000, and a registration fee ranging from Ugshs. 50,000 to 4,000,000.²³⁴ Legal systems characterized by low regulatory burden, shareholder and creditor rights protection, and efficient bankruptcy processes are associated with incorporated businesses and increased access to finance.²³⁵ On the other hand, inadequate legal protection is associated with limited business incorporation, low joint entrepreneurial activity, and higher financing obstacles. These impediments are what De Soto refers to as the mystery of legal failure. He argues that although nearly every developing and former communist nation has a formal property system, most citizens cannot gain access to it and their only alternative is to retreat with their assets into the extra legal sector where they can live and do business.²³⁶

231 Hernando De Soto, *The Other Path: The Invisible Revolution in the Third World* 131 (1989).

232 *Id.* at 132-51.

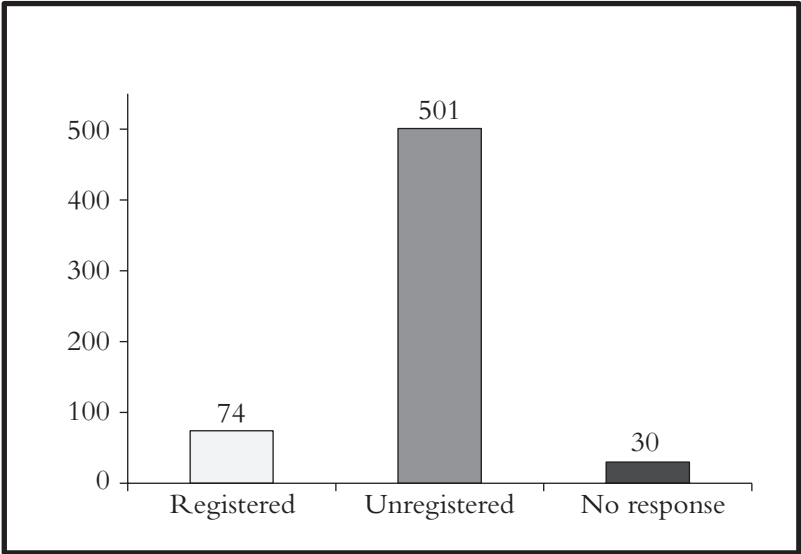
233 *Id.* at 151-77.

234 The Companies Fees Rules, schedule 2, Statutory Instruments Supplements No. 20 of 2005.

235 Asli Demircuc-Kunt, Love Inessa & Vojislav Maksimovic, *Business Environment and the Incorporation Decision*, 30 *Journal of Banking and Finance*, 2967 (2006).

236 Hernando De Soto, *supra* note 1 at 153

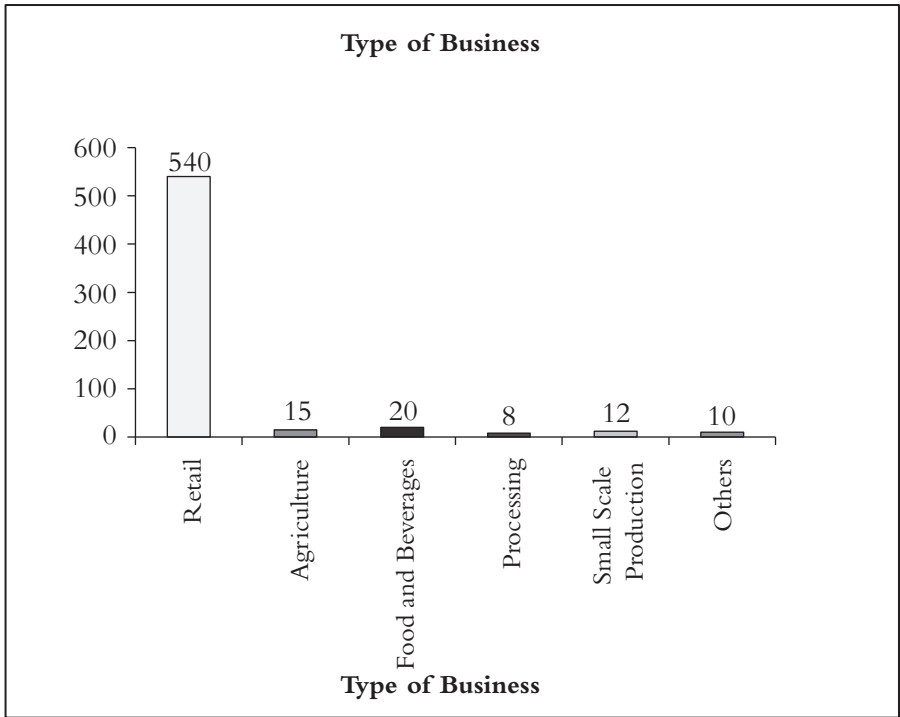
Figure 4: Business Registration



5.1.2 Type of Business

The majority of micro enterprises are engaged in retail trade, such as a shop selling merchandise such as groceries, household items, clothes, motor vehicle spare parts or books. Some respondents reported other business activities including agriculture (bee keeping, milk production), processing (honey, herbal medicines), small scale production (timber and furniture), and services (hair dressing, restaurants selling food and beverages). However, these respondents were few compared to those who reported engaging in retail business.

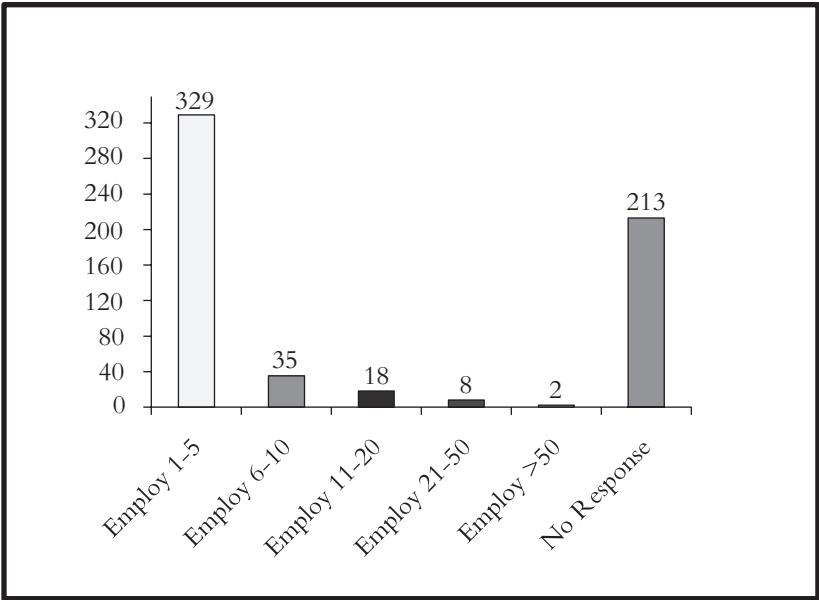
Figure 5: Business Activity



5.1.3 Employment

The number of employees of a business is one of the factors used to classify micro, small and medium enterprises. Although no standard definition specifies a minimum or maximum number of employees for these categories, micro enterprises are on the lower end of the scale regarding capacity to employ. The data show that the majority of micro enterprises in Uganda employ between one and five persons, indicating that the businesses are largely a source of self-employment rather than of large scale job creation.

Figure 6: Persons Employed by Micro Enterprises

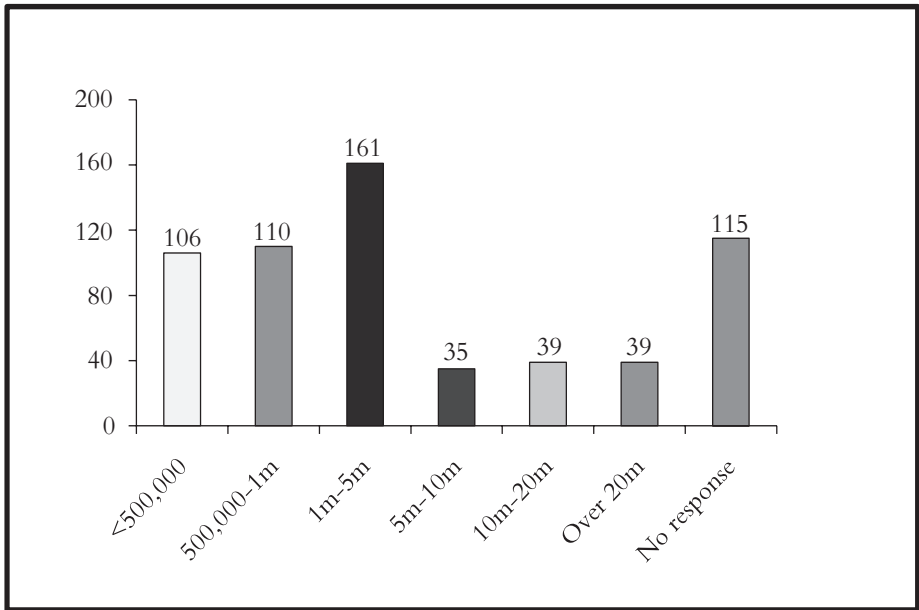


5.1.4 Size of the Business

Size is another indicator used to classify businesses as micro, small, medium and large scale enterprises. However, like the employment variable, size is not consistently defined. In the European Union, business enterprises that have assets not exceeding 2 million Euros are classified as micro enterprises, while those with assets not exceeding 10 million Euros are small enterprises, and a medium enterprise has assets not exceeding 34 million Euros.²³⁷ The data show that the majority of micro enterprises in Uganda have assets not exceeding Ugshs. 5 million. This finding is indicative of the manner in which these businesses are set up — as small, informally established, sole proprietorship businesses initially financed with little start-up capital, usually from informal sources. Because most micro enterprises neither keep financial records nor are audited, respondents were simply asked to estimate the value of their businesses as a going concern.

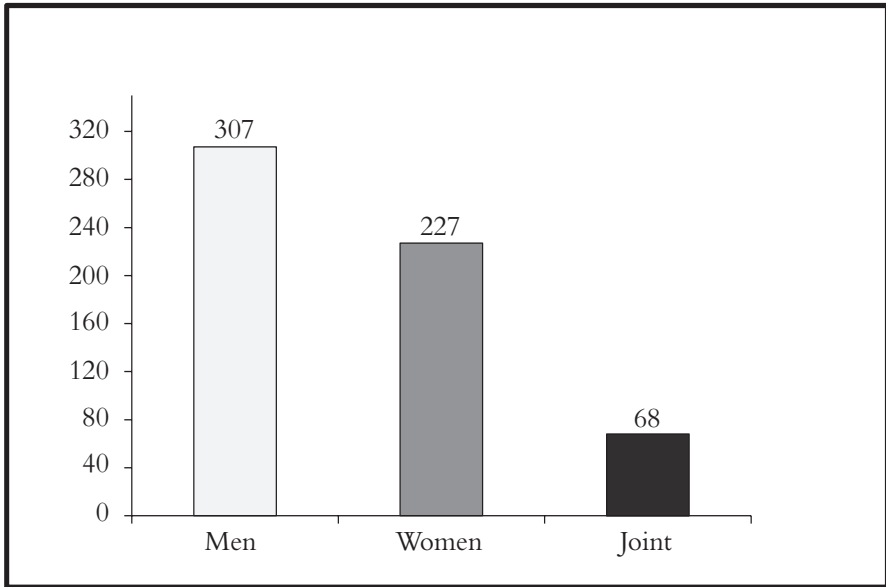
²³⁷ The New SME Definition: User Guide and Model Declaration, 13-14. Enterprise and Industry Publications, European Commission, 2005.

Figure 7: Estimated Size of Micro Enterprises as a Going Concern



5.1.5 Ownership of Micro Enterprises

There were slightly more micro enterprises owned by men than by women. This trend was the same in the different regions of the country. Only 68 micro enterprises were jointly owned, and, in most cases, the co-owners were either spouses or siblings. The low level of joint enterprise is not only typical of micro enterprises but also of other forms of business enterprises in Uganda as well. This is may be due to inadequate legal protection for shareholders. The current Companies Act was enacted in 1948 and is out of date with current corporate governance standards.

Figure 8: Ownership of Micro Enterprises

5.2 MICRO ENTERPRISE FINANCE: DETERMINANTS OF FINANCING DECISIONS

Several factors influence the financing decisions of micro enterprises, including the choice of using informal or formal credit, borrowing from microfinance lenders or commercial banks, and accessing credit individually or through group lending. The latter decision, for example, may be influenced by the credit history of the borrower and the availability of collateral. If a business has neither a prior relationship with a financial institution nor substantial collateral, it may find obtaining credit difficult and instead do so through group lending. Although micro enterprises are easy to establish and usually obtain start-up capital from personal resources, access to formal credit is critical for subsequent growth. Below I discuss the findings on various factors that influence the financing decisions of micro enterprises.

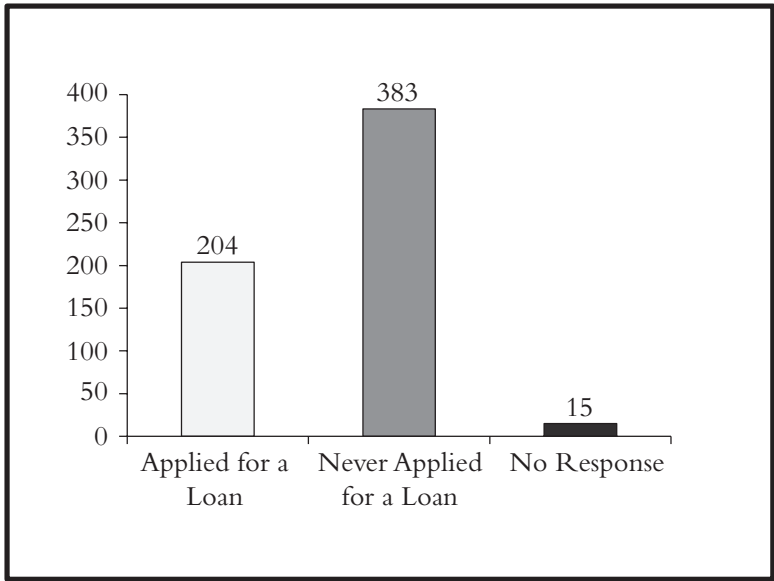
5.2.1 Access to Formal Credit

Out of the 602 respondents, 204 micro enterprises stated that they had applied for a loan, while 383 had never applied. An analysis of the respondents by business location did not reveal any regional advantages in access to formal credit. In Kampala,

only 98 out of 318 enterprises applied for a loan; in the north and north-western region, 46 out of 101; in the western region 30 out of 70; and in the eastern region, 40 out of 113. Therefore, in all the regions, the number of micro enterprises that had applied for a loan is significantly smaller than the number that had never applied.

Although the census of microfinance institutions shows that the central and western regions have a significantly higher distribution of microfinance institutions than the northern and eastern regions,²³⁸ the statistics on access to formal credit do not reflect that bias. In addition, analyzing the respondents by ownership did not reveal any gender related constraints. No significant variations were observed between enterprises owned by men that applied for credit and those owned by women.

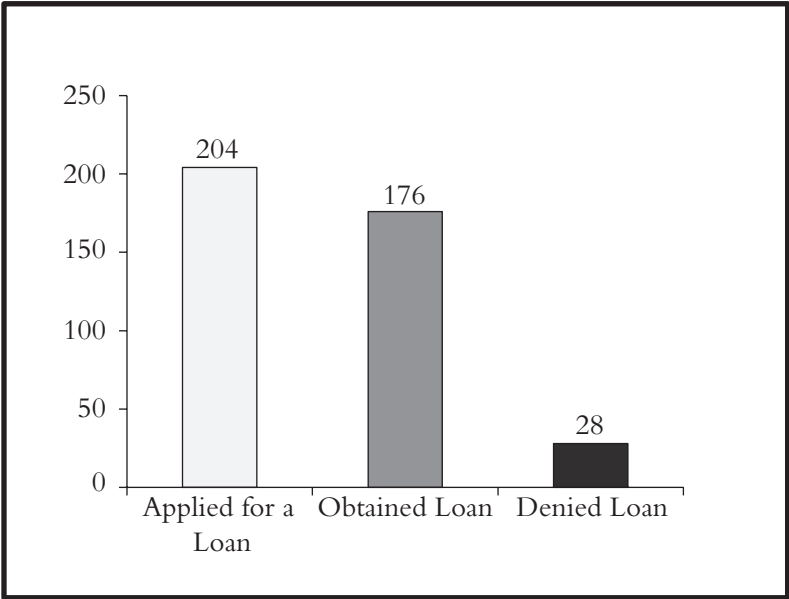
Figure 9: Access to Formal Credit Markets



Of the 204 respondents who stated that they had applied for a loan, 176 actually obtained credit, while 48 were denied credit for reasons discussed below. However, of the 48 respondents denied a loan, 20 have obtained formal credit on other occasions. Therefore, only 28 enterprises that applied for a loan on one or multiple occasions failed to get credit.

²³⁸ The western region has the highest number of MFIs (318) and MFI outlets (448), followed by the central region (201 MFIs and 323 MFI outlets). The eastern region has 157 MFIs and 205 MFI outlets, while the northern region has 65 MFIs and 88 MFI outlets. Luke Okumu, *supra*, note 9.

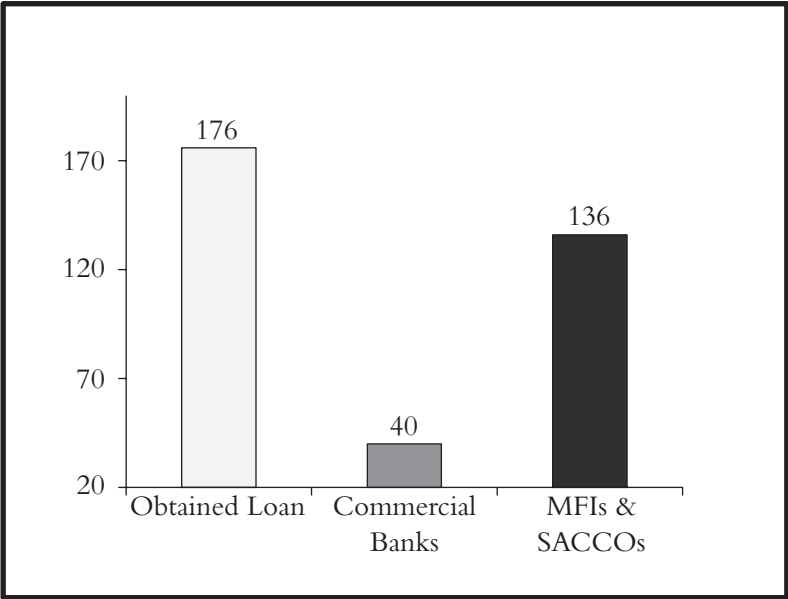
Figure 10: Applied for and Obtained Credit



5.2.2 Source of Formal Credit

For the 176 enterprises that applied for and obtained credit, the majority (136) borrowed from microfinance institutions, while only 40 borrowed from commercial banks. This phenomenon can be attributed to the nature of micro enterprises. Being informally established, requiring small loans, and not having substantial collateral make access commercial bank credit difficult.

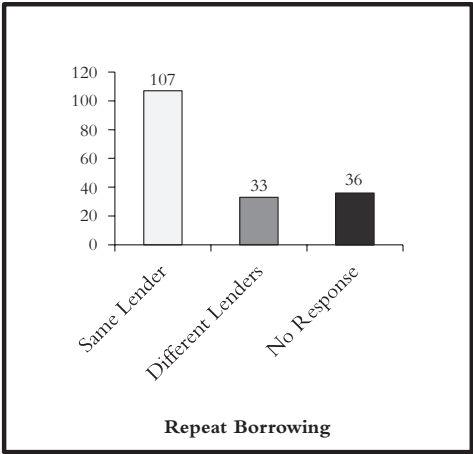
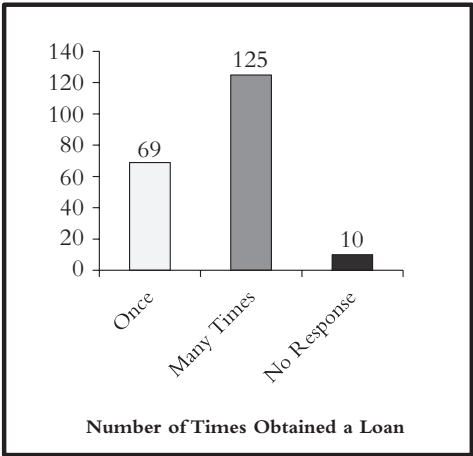
Figure 11: Source of Credit



5.2.3 Borrowing Trends of Micro Enterprises

An analysis of the borrowing trends of micro enterprises that applied for formal credit revealed that the majority applied for credit more than once with the same lender. This pattern is attributed to the fact that most micro enterprises need credit to finance working capital. Therefore, repeated borrowings are indicative of a revolving financing activity. In addition, micro lenders use contingent credit to minimize the risk of default, so borrowers get into a cycle of repeated borrowing of small loans. Another factor that may explain this trend is that once a relationship has been established with a particular lender, borrowers find it easier to obtain subsequent credit from that lender.

Figure 12: Borrowing Trends of Micro Enterprises



The respondents were also asked whether, prior to obtaining credit, they had adequate information about cost and the consequences of defaulting. The majority indicated that they were aware of both and that they had obtained this information either from the lender or from friends.

Figure 13: Information Prior to Obtaining Credit - Cost of Credit

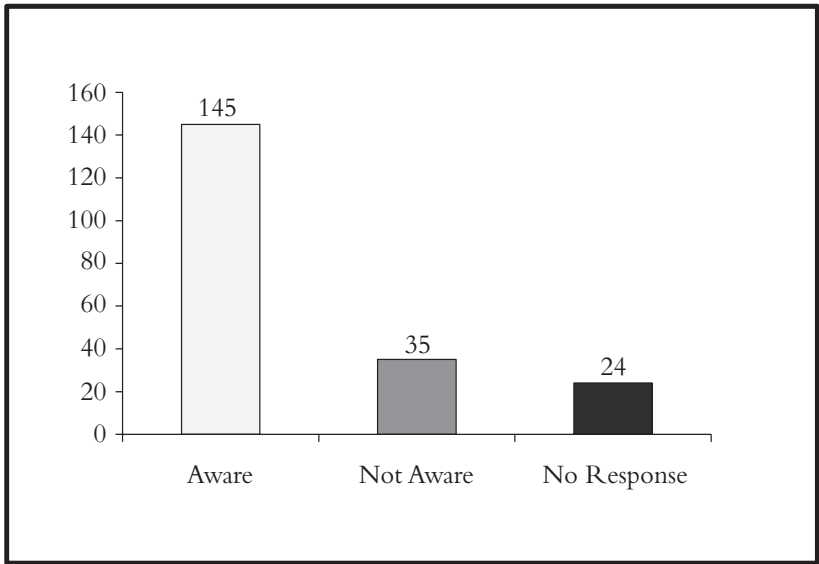
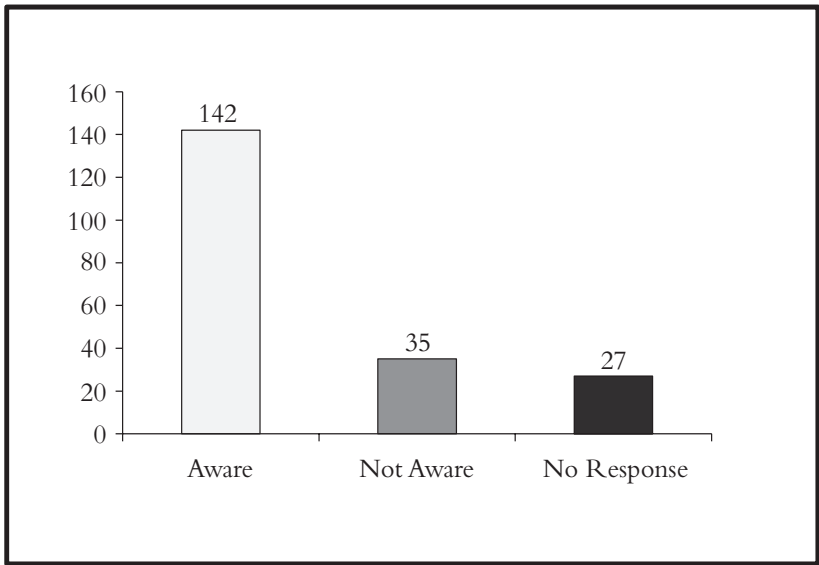


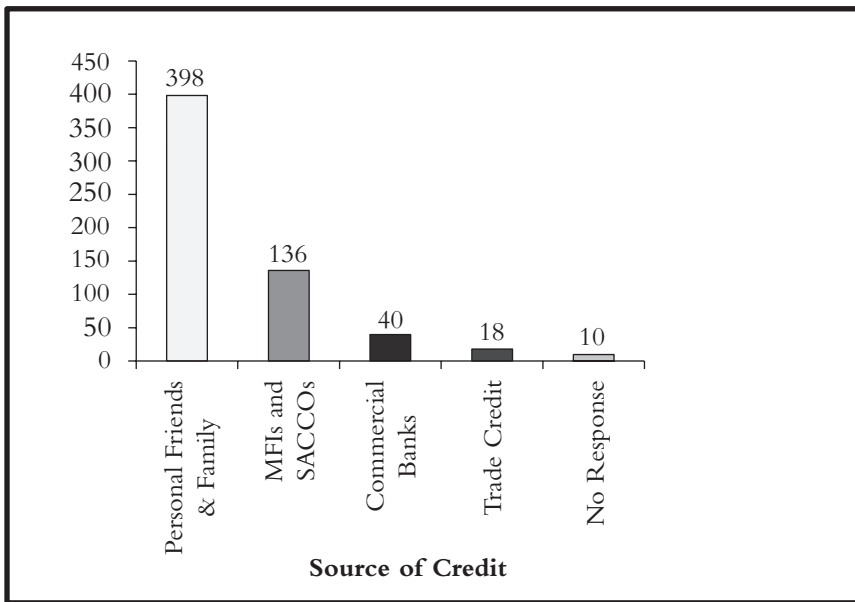
Figure 14: Information Prior to Obtaining Credit - Default Consequences



5.3 COSTS OF CREDIT AND MICRO ENTERPRISE FINANCE

Out of the 602 micro enterprises that responded to the survey, 416 stated that they finance their businesses using personal funds, credit from friends and family, and trade credit. This category is significantly higher than the 176 respondents who stated that they use formal credit to finance their businesses. This clearly shows that despite efforts to increase access to credit, particularly micro credit, informal credit plays a more significant financing role than formal credit. The reasons for not accessing formal credit are discussed below.

Figure 15: Micro Enterprise Finance



5.3.1 Need for Formal Credit

The fact that the majority of micro enterprises do not use formal credit is consistent with other studies in Africa, such as Ghana,²³⁹ Zimbabwe,²⁴⁰ and Kenya²⁴¹ that show extensive use of trade credit and other forms of informal finance rather

²³⁹ Marcel Fafchamps, *supra*, note 139

²⁴⁰ Marcel Fafchamps *et. al.*, *supra* note 123.

²⁴¹ Marcel Fafchamps *et. al.*, *supra* note 109.

than formal credit. However, it is important to distinguish between the use of and the need for credit. Using informal credit does not necessarily mean that there is no need for formal credit. In this study, only 42 of the 383 respondents who use informal reported they did not need credit. In addition, some of the reasons given, show that there is a need for credit but for various reasons, they opted not to use formal credit. Some of the reasons given were that banks charge interest on loans which, is prohibited by religion, “loans have no luck”, “banks steal your property when you borrow from them,” and “I re-invest all my profits into the business so I do not need a loan.” The last reason clearly points to the fact that the respondent does not need a loan. However, the other reasons are cost of credit factors.

5.3.2 Cost of Formal Credit

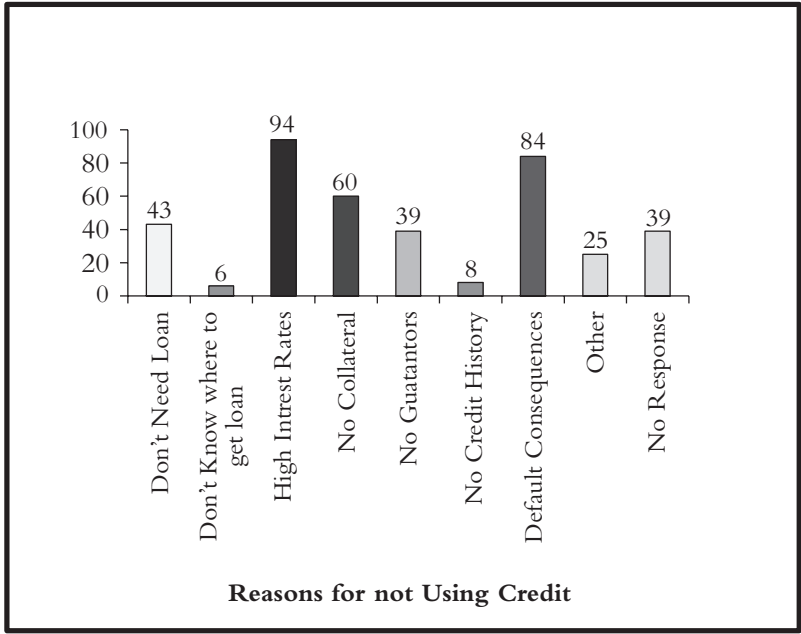
The respondents who were denied credit cited various reasons for failing to obtain credit, including lack of collateral, lack of guarantors, and lack of credit history. The dominant reason was lack of collateral. Out of the 204 respondents who applied for a loan, 48 were denied credit, of whom 25 attributed it to lack of collateral, three to lack of guarantors, and two to lack of credit history. The remaining 18 respondents gave other reasons, including operating a business engaged in an activity that was not financed by a particular lender, such as agriculture, being located outside the geographical radius within which the lender operated, and inability of the lender to meet the borrower's financing needs. Some respondents stated that they failed to obtain credit because they did not comply with the lender's requirement to join a group since they preferred to borrow on individual basis.

The fact that lack of collateral is the major obstacle to accessing formal credit indicates that despite “innovative” lending methods that use collateral substitutes, lenders prefer collateral. During the interviews, the respondents who had applied for and obtained credit, cited collateral as a key loan requirement more often than any other. The other explanation for failure to obtain credit due to lack of collateral, is perhaps that micro enterprises are reluctant to obtain credit through group lending and through other lending methods that use collateral substitutes. This is supported by the fact that of the 121 micro enterprises that were interviewed, only 62 used formal credit, of which 41 obtained loans individually with collateral as security, while 21 borrowed through group lending without pledging collateral.

5.3.3 The Choice between Formal and Informal Credit

There were several reasons given by respondents for not financing their businesses using formal credit. These included: high interest rates and other loan expenses; fear of default and its consequences; lack of collateral, credit history, or guarantors; and simply not needing a loan. Some respondents also stated they were discouraged from obtaining credit by the harassment, intimidation and other underhanded methods used by lenders to ensure loan repayment.

Figure 16: Reasons for Not Obtaining Credit



High interest rates, fear of default and its consequences were the leading factors that discouraged borrowers from accessing formal credit, followed by lack of collateral and lack of guarantors, respectively. Therefore, although micro lending uses mechanisms designed to ease entry into the credit market, as well as to minimize the risk of default, the cost of credit still significantly prohibits using formal credit.

The average interest rate charged on loans from MFIs and SACCOs ranged from a flat rate of 1% to 4% per month. A few lenders charged interest rate on

a declining balance basis, while the majority applied flat rates, which were often converted into weekly or monthly installment payments. Therefore, most borrowers did not know the actual interest rate charged on their loan, but knew what they are required to pay back weekly.

Lack of credit history and not knowing where to obtain credit were the least common factors prohibiting micro enterprises from accessing credit. The latter can be attributed to the increased outreach of MFIs. Regarding the formers, because micro lending methods do not require a loan applicant to have a prior credit history to obtain credit, this factor is not a significant access to credit barrier.

Conclusion

Micro enterprises require very minimal initial capital and skills to set up. Their defining characteristics are similar throughout Uganda and their economic contribution is largely confined to non-agriculture informal sector self-employment. Their financing constraints provide an insight into the dynamics of micro enterprise finance. While start-up capital may be mobilized from informal sources, including personal savings and credit from friends and family, the failure to subsequently use formal credit can severely limit their growth potential.

Proponents of microfinance see it as a tool for broadening access to credit for those who face severe credit constraints. The fact that the majority of micro enterprises use informal finance, as opposed to formal credit, and have real credit needs, indicates that there are some costs of credit that current micro lending methods have not been able to overcome. Contrary to previous assumptions, the widespread use of informal finance may not mean there is no demand for formal credit, rather that costs of credit remain too high. In the next chapter, I analyze the micro lending methods to determine to what extent they ease costs of credit for micro enterprises, and to establish why, despite innovative lending, micro enterprises remain unable to access formal credit.

CHAPTER SIX

6.0 MICRO CREDIT: LENDING METHODS AND ACCESS TO CREDIT

The design of credit contracts is influenced by many factors, including the nature of the credit market, of the borrower, and of the transaction. Micro credit contracts adopt features that are designed to mitigate the risks of adverse selection and moral hazard. In this chapter, I assess (1) the impact of lending methods adopted by micro credit institutions, (2) the factors that influence the choice of lending method, (3) borrowers' attitudes towards them and (4) the extent to which the lending methods improve access to credit. My analysis begins with loan applicant screening mechanisms and proceeds to monitoring and enforcement measures.

6.1 EX-ANTE SCREENING OF LOAN APPLICANTS

Apart from the recently established credit reference bureau, Uganda lacks credit information infrastructure. Also the majority of micro credit users operate in the informal sector. Therefore, formal credit screening, such as the use of credit reports, financial and bank statements, are not widely used. Instead, creditors rely on "soft informal information" gathered about potential borrowers. Some of the techniques used to obtain information about loan applicants include: peer/group selection, information obtained from local council leaders, savings and membership requirements, and use of guarantors.

6.1.1 Peer/ Group Selection

"Group guarantee loans have enabled us to access loans from MFIs. We have sometimes lost money by paying for people who default but we are now more careful. We will not allow anyone who has previously defaulted on a loan to join our group". **Silvia and Grace, proprietors of hair dressing businesses belonging to the same group.**

Peer selection of borrowers is commonly used in group guarantee loans. Potential loan applicants who lack collateral to enable them obtain credit individually, but wish to obtain credit, organize themselves into groups, usually of five people, and apply for a loan on the strength of the group guarantee. Usually the five people know each other, as well as each other's businesses and residence. Some of the factors taken into account in peer selection include the individual's character and reputation, her personal and business assets, and her ability to be traced in

the event of default. Group members are required to visit each other's place of business and residence to verify the existence of a business and the group member's assets.

Assets usually include household items such as a refrigerator, a television set, and furniture, while an assessment of the group member's business would take into account its nature, stock, business assets and ability to generate enough revenue to pay back the loan. Having group members or their peers engaged in a similar business can help the group assess the individual's capacity to repay. Self-selection through peer groups reduces the risk of adverse selection because of the information that group members have about one another. The information would otherwise not be available to a lender, making distinguishing between good and bad borrowers difficult. The group structure shifts the ex-ante screening function from the lender to the borrower because the borrowers have more information about each other. Furthermore, borrowers can efficiently obtain information about each other because of the underlying incentive -- only potential borrowers willing to act in a transparent manner by providing information to their peers, will be accepted to join a group.

The five group members are usually placed into a larger group of 30 to 50 people in which each member, in addition to completing the required forms and complying with other loan application formalities, personally makes an oral application for the desired loan amount to all members of the larger group. All members must agree before the loan is disbursed. Any member can object if she has adverse information about the applicant. Most MFIs operate within a particular geographical area, which facilitates weeding out bad borrowers or those who provide false information because the applicants are likely to be known to each other. This process screens out bad borrowers at no cost and effort to the lender. During preliminary meetings, potential loan applicants are informed about the structure of group guarantee loans, and about their responsibility to select group members who are capable of repaying the loan.

“This MFI will not lose money under any circumstances. If any of your group members fails to pay the loan, each of the members of the group will contribute proportionally to the defaulter's unpaid loan. Therefore, it is important to select group members who will not default”. **Training officer at an informational meeting for potential loan applicants.**

Peer/group selection has historically been used in various parts of the world as a tool to minimize adverse selection, and was more recently pioneered by institutions

such as the Grameen bank of Bangladesh and replicated in several countries. Various studies have shown the dynamics of peer selection, including the impact of voluntary and involuntary selection on group repayment rates,²⁴² its role in minimizing adverse selection because of the informational advantages group members have over creditors,²⁴³ and its ability to minimize ex-ante moral hazard.²⁴⁴ However, sometimes group members have adverse information about their peers but chose not to inform the lender. For example, some respondents stated that they were aware that some group members were multiple borrowers, or did not have the assets claimed, or that they were going to use the loan for a purpose other than the one disclosed when submitting their application. They stated that as long as, in their judgment, the person was not of bad character and his or her business was able to generate enough revenue to pay back the loan, they would ignore the adverse information.

Screening by joint borrowers is different from screening by joint or multiple lenders. In the former, the screening is performed by all borrowers in the group, and each borrower has an incentive to participate in the screening process to minimize the risk of default. Default by a group member increases the cost of borrowing for other group members, who as a result of the group guarantee, have to pay for the defaulting member. In the case of multiple lenders, the screening does not necessarily have to be done by all the lenders because actions by one lender may serve as a signal to the others. This signaling effect is especially likely when one lender has more information than the others or is able to perform the screening function more efficiently and cost effectively than the others. If the lender declines to extend credit, then the other lenders are likely to take their cue from those actions.²⁴⁵ However, signaling has its limitations such as the free rider effect, or when the signal is picked up too late to be able to take any meaningful action.²⁴⁶

242 Timothy Besley & Stephen Coate, *Group Lending, Repayment Incentives and Social Collateral*, 46 *Journal of Development Economics* 1 (1995).

243 Beatriz Armendáriz de Aghion & Christian Gollier, *Peer Group Formation in an Adverse Selection Model*, 110 *Economic Journal* 632 (2000); Maitreesh Ghatak, *Group Lending Local Information and Peer Selection*, 60 *Journal of Development Economics* 27 (1999); Eric Van Tassel, *Group Lending Under Asymmetric Information*, 60 *Journal of Development Economics* 3 (1999).

244 Joseph E. Stiglitz, *Peer Monitoring and Credit Markets*, 4 *World Bank Economic Review*, 351 (1990), reprinted in *The Economics of Rural Organization: Theory, Practice, and Policy*, 70-86 (Karl Hoff et. al., eds., 1993).

245 See Eugene F. Fama, *What is Different About Banks?*, 15 *Journal of Monetary Economics* 29, 36-37 (1985) (discussing the credibility of signals from banks as lenders).

246 See George A. Akerlof, *The Market for Lemons: Quality, Uncertainty and the Market Mechanism*, 84 *Quarterly Journal of Economics* 488 (1970) (discussing the concept of signaling).

Borrowers who access credit through peer or group selection are usually women;²⁴⁷ their businesses have no substantial assets; they have no prior experience with formal credit markets and require very small loans. The real value of peer selection is to reduce the information gap between borrowers and lenders, and to provide those individuals, with no formal credit history, an entry point into the credit market. However, sometimes eased entry into the credit markets is only a partial solution to the access to credit problem. As I discuss in Chapter 7, if borrowers are able to determine ex-ante that the costs of group lending far outweigh the benefits of credit market entry, they may not be keen to obtain credit.

6.1.2 Use of Local Council Leaders to Provide Information about Borrowers

In Uganda, micro lenders usually require a loan applicant to produce a recommendation letter from the local council chairman of the area where she resides or conducts business. The letter must confirm that the applicant resides or conducts business in a particular area. The letter will also indicate how long the applicant has been a resident of that area and whether she is a tenant or owns the home in which she lives.

The information is provided at no cost to the lender but is critical for verification purposes, as well as if the borrower defaults, and the lender elects to attach her property. Local council leaders can be a source of valuable information for lenders, particularly in identifying multiple borrowers or individuals with undesirable behavior. They also can inform a lender about how a borrower used loan funds, as well as help a lender who wishes to attach a borrower's assets by identifying her assets. The relationship between local council leaders and micro credit institutions is more often than not ad/hoc and informal.

6.1.3 Screening Borrowers by Geographical location

Because most micro credit lenders serve a limited geographical area, such as within a 30 kilometer radius of the location of the institution, they often provide credit facilities tailored to that area's economic activities while also capitalizing on their loan officer's knowledge about that locality. In addition, although no formal

²⁴⁷ The majority of the respondents stated that more women access credit as part of a group than men do. This phenomenon was attributed to women being less likely to have assets against which they can borrow on an individual basis. Additionally, men prefer to borrow as individuals because they are reluctant to discuss their financial affairs publicly.

mechanism usually exists for sharing information between the various micro credit lenders, loan officers in a particular area often informally share information about their clients. Furthermore, the lending method will also be determined by area dynamics like population distribution (group lending is less used in sparsely populated areas) or location (some lenders believe that groups work better in rural settings than in urban ones).

6.1.4 Savings and Membership Requirements

Another requirement often used by microfinance institutions as an ex-ante screening tool and collateral substitute, is requiring a potential borrower to accumulate savings with the institution from which she intends to borrow money. This requirement may apply to both individual and group borrowers. An individual loan applicant usually must present evidence that she has at least 25 to 30% of the required loan amount, while group applicants must make weekly deposits of specified amounts for a stated period of time, such as Ugshs. 2,000 for four weeks prior to loan disbursement. In this study, 17 micro credit lenders indicated that they require applicants to have prior savings before applying for a loan. The savings can be as low as Ugshs. 10,000 or may be a percentage, which can be as low as 5% or as high as 25%. Some lenders do not state a specific savings amount but instead require the applicant to save for a minimum period, ranging from one to three months.

Savings and Credit Co-operatives require potential borrowers to buy shares and become a member in order to be eligible for a loan. The loan to share value ranges from 1% to 25% of the value of the loan. The amount a member is eligible to borrow usually depends on the level of savings or the amount of shares held. The membership requirement and time it takes to accumulate savings or to acquire shares in proportion to the desired loan-to-share value, enables the lender to establish a relationship with its client. In addition, some micro credit institutions lend to specific groups, such as members of a particular organization. For example only members of Uganda Gatsby Trust are eligible to borrow from Uganda Gatsby Microfinance. Success Microfinance and Pearl Microfinance also began as in-house credit departments of NGO's (Uganda Women's Effort to Save Orphans and Save the Children respectively) and only provided credit to their beneficiaries. However, both institutions have subsequently established themselves as fully fledged microfinance institutions serving a broader clientele than their own members.

6.1.5 The Requirement for Guarantors

The requirement for a loan applicant to have guarantors is fairly standard practice. In this survey, 29 micro credit lenders reported that they require a loan applicant to provide at least two guarantors who have a pre-existing relationship with the institution. The guarantors are usually required to certify that they know the loan applicant and that they will repay the loan in the event of default. The guarantors usually have better information about the loan applicant than the lender and this assists in the screening process because a guarantor will not recommend an individual about whom he has adverse information that is likely to affect her ability to repay the loan. Moreover recommending an applicant who defaults will taint the reputation of the guarantor. Although a guarantee involves some degree of liability on the guarantor's part, in most cases guarantors assist in screening borrowers and putting pressure on a defaulting individual to ensure that the loan is repaid. With the exception of group guarantee loans, guarantors are rarely called upon to repay the loan of a defaulting borrower.

The above screening techniques are all tools used to level information asymmetry. The tools almost entirely shift the cost and burden of screening to the borrower. Furthermore, they reduce lenders' risks, particularly that of adverse selection, although the problem is not entirely eliminated because some bad borrowers slip through the system, and multiple borrowing remains a significant problem. The benefit to borrowers is gaining entry to the credit market. Below I analyze lending methods and monitoring tools used by micro credit lenders to establish the extent to which the methods reduce costs of credit.

6.2 LENDING METHODS USED BY MICRO CREDIT INSTITUTIONS

Micro credit lenders provide credit either on an individual or a group basis. The choice of method depends on the characteristics of the borrower, including credit needs and collateral availability. Borrowers who do not have valuable assets to pledge as collateral and require small loans will usually access credit through group guarantee loans. Some micro credit lenders started out by providing credit primarily through group lending, but adapted to individual loans as the needs and profiles of their clients changed. Both methods have an impact on access to credit, particularly on entry into the credit market.

6.2.1 Group Guarantee/Joint Liability Loans

Group guarantee/joint liability loans enable individuals to access credit on the basis of group guarantees executed by each group member. Usually, the individual borrower has neither a credit history nor substantial assets that would enable obtaining credit independently. The respondents in this study who obtained credit on group basis previously had used personal funds, trade credit, and credit from friends and family to finance their businesses. Various reasons were given for obtaining credit, the most significant being the desire to increase capital stock, followed by the need to purchase personal household items and the need to diversify their businesses. For example, one respondent, who operated a hairdressing business and had gone through five group loan cycles, indicated that she used her first loan to buy a cell phone to enable her communicate with her customers. Her subsequent loan was used to purchase equipment for her business. The third and fourth loans were used to purchase some household items, as well as stock for the business. The fifth loan was used to start up another business to supplement her income from the hairdressing business.

The manner in which groups are set up and other dynamics of group lending are similar irrespective of the nature of the lender. The size of the groups ranges from a minimum of five to a maximum of 40 members. For the majority of institutions, the groups are comprised of five to seven self selected members. In addition to knowing each other, group members usually conduct business or reside in the same location, which facilitates obtaining information and monitoring each other. Most members of a group will usually be engaged in the same type of business, as was particularly the case with respondents in Wandegaya, where the majority were engaged in the hairdressing business. In market areas, such as Kalerwe and Nakawa, the majority owned market stalls where they sell groceries. This trend is indicative of some degree of homogeneity within the groups. However, as I will show in Chapter 7, while studies have shown that group homogeneity positively impacts loan repayment, a distinction exists between group characteristics and individual credit needs. Similar borrower characteristics do not necessarily translate into similar credit needs.

There are two methods of group lending. Credit can be extended to the group as an entity or to individual members of a group. The former is not as commonly used as the latter. If credit is extended to the group as an entity, it will either be formally or informally established as an association, and its members are

usually engaged in joint activity, such as making crafts, processing milk or honey products. The income is jointly distributed, and the members are jointly liable for repaying the loan. The screening process focuses on the group rather than on the individual members, and the requirements for obtaining credit include evidence of the association's constitution, the particulars of its members, and its activities, assets and financial records if applicable.

A group can also obtain credit as an entity but not use the loan for joint activity as described above, rather it is used for onward lending to its members, who are then severally liable for repaying the loan. The group determines how to disburse the loan to the individual members. The repayment obligation is placed on the association, which in turn must monitor members to ensure that they repay their loans. However, this method of obtaining credit is not commonly used as when individual group members obtain credit directly from the lender.

The more common practice is that group members are eligible to borrow individually, and that each person has the primary responsibility to repay the loan within the prescribed time, as well as to comply with other loan obligations, such as attending group meetings, undergoing training, and accumulating savings. However, if a member of the group defaults, the group guarantee automatically kicks in, and each member will, on a pro rata basis, contribute towards repaying the outstanding loan. The lender usually offsets the outstanding loan from each group member's forced savings on a pro-rata basis, and the balance, if any, is equally distributed among the members. The group members are not eligible for further credit until they have fully paid up their loans and the outstanding defaulting member's loan.

The loan amounts available on a group guarantee basis and the repayment period vary from one lender to another, as indicated in table 11 below. Some institutions have a standard "loan menu" that indicates the lowest amount group loan applicants may borrow on a group basis, as well as the progressive amounts for which they are eligible upon successfully repaying the previous loan. Some micro lenders also set a maximum threshold for group loans, above which members can only borrow on an individual basis.

The loan repayment period for group loans varies from one institution to another. At FINCA, the loan repayment period is four to six months; at PRIDE MDI 25 to 50 weeks; at FAULU 18 to 26 weeks, at Ibanda CSCS and Baraka Financial

Services, four months; at Advance Uganda MFI three to 12 months; at PANYIMUR SACCO four to eight months (with an exception for agricultural loans which extend to 12 months); at Masaka Micro Development Cooperative one year (except for agricultural loans which is 18 months). The observable trend for group loans is that repayment schedules are structured on a weekly basis and occasionally on a monthly basis. The average loan duration is under six months, except for a few institutions that extend it to 12 months and, in very rare circumstances, beyond 12 months.

Table 11: Amounts and Repayment Periods for Group Loans at Various Micro Credit Institutions as of 2007

Institution	Loan Range (Ugshs.)	Repayment Period
Advance Uganda MFI	50,000-300,000	12-56 weeks
Success MFI	50,000-300,000	12-56 weeks
FAULU MFI	300,000-2,000,000	18-26 weeks
FINCA MDI	50,000-6,000,000	16-24 weeks
PRIDE MDI	200,000-8,000,000	25-50 weeks
PANYIMUR SACCO	50,000-5,000,000	16-32 weeks
MASAKA MDCS	100,000-5,000,000	56 weeks

The interest rate charged on group guarantee loans varies from 2.5 to 5% per month. Most micro lenders charge a flat rate while a few charge interest on a declining balance. Institutions that specifically provide agriculture finance charge a lower interest on agricultural loans. For example, PANYIMUR SACCO charges a flat rate of 3% per month on all loans except agricultural loans which are charged 2.8%. At Masaka Micro Development Cooperative, the interest on agricultural loans is 2% per month, while commercial loans are charged 2.5 %. Most lenders that provide agricultural finance are beneficiaries of subsidized credit lines either from the government or donor agencies that are specifically designed to support agriculture.

The eligibility requirements for a group loan include: group membership, ownership of an existing business, attending training, accumulating the required savings, a recommendation letter from the local council chairman of where the applicant resides, members' verification reports about each other's businesses,

payment of membership fees and purchase of shares (if the lender is a SACCO). In addition, an applicant must have valid identification, be 18 years of age or older, and reside within an area served by the lender. The requirements are fairly standard.

An evaluation of the respondents who indicated that they had obtained loans through groups shows that they would otherwise not have been eligible for formal credit from other lenders, such as commercial banks. These borrowers are considered risky because of the nature of their businesses and their inability to meet the formal lending requirements of commercial banks. In addition, they require small loans, some are illiterate, and the majority have no substantial collateral other than a few chattels and personal household items. Some of these characteristics are consistent with prior studies showing that at lower levels of wealth, group loans are larger than individual loans and more efficient.²⁴⁸ Because of the nature of micro enterprises (they are established as sole proprietorships with no formal registration of the enterprise and its assets, poor record keeping and accounting), the assessment for eligibility for credit is based on the strength of the enterprise's owner rather than of the enterprise itself. Chattels, business stock and cash flow projections are usually valued by estimation.

Group guarantee loans provide an entry point to the credit market, as shown by the respondents' reasons for joining a group and by their attitudes towards group lending. The majority indicated that they could obtain formal credit only through group lending. Almost all the respondents reported paying for a defaulting group member's loan, either by using forced savings or by paying an amount in excess of their own loan value, in order to remain eligible for another loan. The majority considered paying for a defaulting member as part of the risk of obtaining credit, and appeared to place more value on the opportunity to gain access to credit than on the risk of group liability. Some indicated that they tried to minimize the risk by carefully selecting group members. This practice is consistent with prior empirical studies showing that self-selection, which is largely done through social connections, reduces screening, monitoring, and enforcement costs.²⁴⁹

248 Margaret Madajewicz, *Capital for the Poor: The Effect of Wealth on the Optimal Credit Contract* (Columbia University Job Market Paper, 27, 1999). (Available at <http://www.isnie.org/ISNIE99/Papers/madajewicz.PDF>).

249 Thierry Van Bastelaer, *Imperfect Information, Social Capital and the Poor's Access to Credit* 20 (University of Maryland IRIS Working Paper No. 234, 2000).

Therefore, the real value of the group lending method is to provide an entry point into the formal credit market for those who otherwise would be ineligible for formal credit. Peer selection minimizes information asymmetry and increases the willingness to lend. Prior work on group liability lending has shown that this model is efficient when the borrowers have more information than the lender, and, therefore, borrower monitoring is less costly and more efficient than lender monitoring.²⁵⁰ There is also evidence that group liability loans are more efficient at lower levels of wealth.²⁵¹

However, there are some weaknesses inherent in group lending that explain why some micro enterprises are not keen to access credit using this method. The structure of group loans reduces the risk of default, but, it may disadvantage some borrowers. Group lending provides less credit than individual loans. For the majority of micro lenders, group loans have a lower loan range than individual loans. Also, the repayment period for group loans is shorter than for individual loans. Some respondents reported being discouraged by the low amounts available under group loans, and yet group liability can potentially slow down capital accumulation, thereby wiping out the benefits of accessing credit.

250 Kaarla Hoff & Joseph E. Stiglitz, *Introduction: Imperfect Information and Rural Credit Market-Puzzles and Policy Perspectives*, in *THE ECONOMICS OF RURAL ORGANIZATION: THEORY, PRACTICE, AND POLICY*, 33-52, 49 (Kaarla Hoff *et al.*, eds. 1993) (arguing that groups will have an incentive to bear the burden of screening, monitoring and enforcement where the benefits of doing so far outweigh the costs); See also Beatriz Amendariz de Aghion, *On the Design of a Credit Agreement with Peer Monitoring*, 60 *Journal of Development Economics* 79 (1999); Beatriz Armendáriz de Aghion & Christian Gollier, *Peer Group Formation in an Adverse Selection Model*, 110 *Economic Journal* 632 (2000); Joseph. E Stiglitz, *Peer Monitoring and Credit Markets*, 4 *World Bank Economic Review* 351 (1990), reprinted in *THE ECONOMICS OF RURAL ORGANIZATION: THEORY, PRACTICE, AND POLICY*, 70-86 (Kaarla Hoff *et al.*, eds. 1993); Maitreesh Ghatak & Timothy W. Guinnane, *The Economics of Lending with Joint Liability: Theory and Practice* 60 *Journal of Development Economics*, 195 (1999); Abhijit V. Bernerjee, Timothy Besley and Timothy W. Guinnane, *Thy Neighbor's Keeper: A Theory of Credit Cooperatives* 109 *Quarterly Journal of Economics*, 491 (1994); Joel M. Guttman, *Repayment Performance in Group Lending Programs: A Survey* (Indiana State University Networks Financial Institute Working Paper No. 1 of 2006) (analyzing theoretical and empirical work on group lending. He concludes that while the theories advanced point to the fact that group lending shifts responsibilities to the party who can perform them more efficiently, in this case the borrowers because they have more information than the lender, are able to monitor each other, and use social sanctions to enforce repayment, empirical evidence on determinants of repayment rates is contradictory).

251 Margaret Madajewicz, *supra* note 248.

Table 12: Comparing Group and Individual Loans

	Group Loans	Individual Loans
Processing time	On average 4-6 weeks due to group formation and pre-loan training	On average 1-2 weeks
Loan Processing Fee	Paid	Paid
Loan Insurance Fee	Paid	May be required
Pre-Loan Savings	Required	May be required
Initial Loan	Fixed by lender and usually in small amounts	No fixed initial amounts; amount borrowed depends borrower's capacity.
Cost of Credit	Interest rates for group loans are on average higher than for individual loans. Joint liability also increases the cost of credit	Interest rates and other charges generally lower for individual loans
Collateral	Collateral substitutes	Required
Repayment Method	Weekly/ Monthly	Monthly
Repayment Period	Shorter than individual loans, usually under 1 year	Longer repayment period, sometimes over 1 year
Loan Repayment Rates	Higher than individual loans, on average between 95-98%	Lower than group loans and for some lenders, repayment rates can be as low as 85%.
Guarantors	Required	Required

6.2.2 Individual Loans

Credit can also be obtained on an individual basis. However, unlike group guarantee loans, the applicant must have collateral, such as land or chattels, as well as guarantors who undertake to pay the loan in the event that the borrower defaults. Most micro credit lenders do not place a limit on the amount that can be borrowed on an individual basis. It usually depends on the value of collateral provided, the bor-

rower's credit needs, and her capacity to pay back the loan, which is assessed on the basis of several factors including the borrower's cash flow. On average, lenders require the value of collateral to be between 120% and 150% of the value of the loan. The borrower is required to provide proof of ownership of collateral, which may be evidenced by formal registration, a purchase agreement, or photographs. Although both formal and informal evidence of title are used, the former is critical when the amount to be borrowed is substantial (usually above Ugshs. 5 million).

Since micro credit typically involves small loan amounts, lenders accept land purchase agreements and photographs as evidence of collateral ownership, especially chattels. In rural areas, unregistered collateral is commonly used because of the land tenure system and difficulties in registering property. In cases of lending against chattels, photographs can suffice to prove ownership, and a loan officer is required to visit the premises and verify that the particular items exist. To minimize the risk of multiple pledging of collateral, lenders either take an equitable mortgage or set a maximum amount can be borrowed against unregistered collateral. Loans are also insured against death and disability, thereby reducing risk for the lender but increasing the cost of credit.

For most micro credit lenders, group borrowers outnumber individual borrowers. However, in terms of volume, the value of individual loan portfolios exceeds that of group guarantee loans. They also have longer repayment periods, and sometimes the interest rate charged is slightly lower than that charged on group loans. However, on average, repayment rates are lower for individual loans. In terms of borrower's attributes, the following general characteristics have been observed: individual loans are dominated by men; ex-ante screening incorporates some formalities associated with commercial bank lending; processing time for applications is shorter; individual loan applicants usually have prior banking relationships with the institution, either as customers or as creditors who have graduated from the group loan schemes; and monitoring is less rigorous than for group loans.

A key distinction between group guarantee loans and individual loans is that, for group loans, the character of the individual, which is assessed by her peers, is critical, as well as the ability to generate income to make weekly repayments. On the other hand, with individual loans, the most important consideration is the individual's capacity to repay the loan, which is assessed by what the individual

presents to the lender. Compared to group loans, individual loans are less costly to administer. This factor has forced some micro credit lenders to focus on building their individual loan portfolios. For example, FINCA and Uganda Finance Trust started out as microfinance institutions lending primarily to women on group basis. However, they consequently introduced individual loans and provided credit to men as well. Centenary bank's micro credit loans are all provided on an individual basis.

6.3 BORROWER MONITORING

Micro credit lenders use various mechanisms to monitor borrowers. Some of them are intensive and time consuming for credit officers, while in other cases, particularly for individual loans, less intensive monitoring methods are applied.

6.3.1 Peer/Group Monitoring

This mechanism is used in group guarantee loans. The group members are required to monitor each other by keeping track of their members and reporting any adverse information to the lender. The group leader is required to visit the business premises of the members on a weekly basis. In addition, members meet weekly at the lender's premises to discuss among other things, progress with loan repayment and to make the weekly deposits. Frequent meetings and close proximity make it easier for members to monitor each other. Monitoring by group members is not as stringent as portrayed in the literature. Most individuals interviewed who had borrowed money through group lending reported that it is common practice to apply part of the loan to personal uses rather than business ones, or to use part of the loan for a purpose contrary to what was stated in their loan applications. This was rarely a cause for concern and was almost always never reported to the lender. The majority of respondents indicated that, even when part of the loan was used for personal rather than business purposes, the returns on the portion used for business were sufficient to enable them repay the entire amount.

Conduct that caused concern among group members included the inability to trace a group member and the failure to make timely installment repayments. Some respondents also stated that they were aware that some group members belong to multiple groups. However, this fact would only be a cause for concern if the group member were to experience difficulties in repaying the multiple loans.

Borrower monitoring reduces costs for both borrowers and lenders because, to the extent that those who obtain a loan honor their obligations, the lender's risk of default is minimized. The benefits for borrowers are twofold. First, a reduced likelihood of default within the group reduces the probability of having to repay a defaulting member's loan. Second, lenders are more willing to extend credit if the perceived risk of default is minimal, which should increase access to credit. However, borrower monitoring has its own weaknesses. Borrowers will only actively monitor if the benefit of doing so outweighs the cost. In addition, the manner in which it is done may involve wasteful and time consuming duplication of activity because the exercise is performed by all group members and no mechanism exists for assigning the monitoring role either to one member on behalf of the group, or to the person most able to do it. Having all members monitor each other through visits and joint meetings has its advantages and disadvantages. They have access to information about each other as a result of constant contact, may make useful business contacts, and are also able to apply pressure or persuasion to ensure that each member repays their loan. However, these visits and joint meetings can also be time consuming.

The inability to allow for the monitoring function to be performed by one party for the benefit of others is a feature that distinguishes monitoring by borrowers from that done by lenders. Multiple lenders can benefit from monitoring by one lender, particularly one with access to information about the borrower and is able to monitor efficiently at least cost. This kind of monitoring may be prone to problems such as free riding, but, on the whole, it is more efficient to have a particular function performed by one party as opposed to everybody engaging in the same activity.²⁵²

6.3.2 Monitoring by Credit Officers

With group guarantee loans, credit officers usually monitor client accounts to ensure that weekly repayments and forced savings are up to-date. They also facilitate group meetings, particularly when contentious issues must be resolved among group members. However, with individual loans, credit officers often make scheduled and impromptu visits to the borrower's business premises. The frequency of monitoring varies. During appraisal, at the start of the loan, and if the borrower experiences

252 For a discussion on cooperative and competitive monitoring, see George G. Triantis, *Secured Credit Under Conditions of Imperfect Information*, 21 *Journal of Legal Studies* 225, 241-45 (1992). See also Robert E. Scott, *A Relational Theory of Secured Financing*, 86 *Columbia Law Review* 901, 931-32 (1986) (discussing coordinated monitoring as a public good).

difficulty in repaying, the visits are more frequent. In addition, because most micro credit lenders serve clients within relatively small areas, it is easier for credit officers to monitor borrowers, as well as pick up any information about potential and current borrowers.

Monitoring individual loans is done mainly by relationship lending. Berger and Udell define relationship lending as a technique based significantly on soft, qualitative information gathered through contact overtime and from members of the local community. The soft information may include the character and reliability of the borrower, based on direct information obtained over time by the institution's loan officer; the payment and receipt history gathered from past loan transactions, deposits or other services provided by the lender; or the borrower's future prospects garnered from her customers, suppliers, or neighboring businesses. This soft information may often be proprietary to the loan officer and may not easily be observed, verified, or transmitted by others within the financial institution.²⁵³

The general practice is that each individual credit officer has a loan portfolio that they oversee. This responsibility starts prior to lending when a borrower approaches the micro credit lender for a loan. The borrower is assigned to a credit officer who is responsible for appraising the loan application. This includes evaluating the client, visiting the client's premises, and obtaining information about the client from both formal and informal sources. Depending on the evaluation and the value of the loan that the client requires, the loan officer makes a recommendation to the bank either to grant or deny credit to the applicant.

Loan officers base their assessment on various factors, including an evaluation of the loan applicant. Loan officers stated that, during preliminary discussions with clients, they look for inconsistencies in the information that a client provides, such as profit and income statements that contradict bank records, and information about the applicant's business that is inconsistent with the general business environment or with similar businesses. The applicant's character, capacity to repay, cash flows, capital, ability to comply with loan conditions, and collateral are all important considerations when evaluating a loan application.

When a loan is disbursed, the relationship between the borrower and the loan officer takes on another dimension. The loan officer constantly monitors the borrowers' bank account to assess cash flows and the borrower's ability to make

253 A.N Berger & G.F Udell, *A More Complete Conceptual Framework for SME Finance*, 30 Journal of Banking and Finance 2945, 2948 (2006).

scheduled repayments. In addition, loan officers are expected to make scheduled and unscheduled visits to the business premises as a means of monitoring the borrower's business and also to ensure that the borrower has not disposed of any chattels that are pledged as collateral. Loan officers also obtain general business information to enable them evaluate their clients capacity to repay. This includes information on issues such as multiple borrowing, taxes, regulatory action, floods, fires, and political factors that adversely affect import and export activity, such as closure of borders.

The various monitoring tools enable loan officers to determine whether failure to repay is deliberate or is a result of general business failure, and to determine appropriate action. For example, a loan officer can easily detect deliberate default when a borrower's business is performing well but the borrower fails to make regular payments. In this case, either the borrower is banking elsewhere or is diverting the money to some other purpose.

Relationship lending can be problematic for various reasons. First, it increases the cost of borrowing because of the manpower and resources involved. This problem has been identified as one of the key inefficiencies of micro credit lenders in Uganda.²⁵⁴ Second, relationship lending has the potential to create agency problems for the lender. This may arise when, because of monetary incentives for recruiting new clients, loan officers approve unsuitable borrowers. Third, loan officers may develop close relationships with borrowers that cause them to overlook and underreport adverse information. Some respondents reported that loan officers expect side payments from borrowers who they monitor, a factor that may affect their ability to repay a loan or their eligibility for future loans. Lending institutions have adopted measures to minimize these problems, including discouraging borrowers from paying bribes,²⁵⁵ attaching loan officer incentive payments to successful loan repayment, appointing supervisors to monitor loan officers, and rotating loan officers.²⁵⁶

254 In an interview with Charles Kulibanza Byanyima, the Executive Director of the Microfinance Support Centre, an institution that provides wholesale credit as well as subsidized credit from government and multilateral agencies to micro credit lenders, he stated that the benefits of subsidized credit are not enjoyed by borrowers because of inefficiencies in the operations of micro credit lenders that translate into higher costs of borrowing.

255 Centenary Bank and PRIDE Microfinance have posters in their banking halls discouraging payment of bribes and providing contact information for borrowers to report loan officers who solicit bribes.

256 Success Microfinance indicated that it uses this tool to minimize risk of improper conduct, as well as to ensure business continuity when loan officers resign.

Although relationship lending can improve access to credit, it can also create another form of credit constraint. Information obtained as a result of the loan officer-borrower relationship is not formally transferable to another institution, and thus, constrains creditor choice. Furthermore, considering that this mechanism is typically used by small lenders, it presents an access problem to the extent these small lenders are not able to meet the borrowers' demands. For example, some SACCOs and MFIs ration credit when they are unable to meet borrowers' demands. As a business expands and demands larger amounts of credit than a SACCO or MFI can provide, the borrower, who previously could access credit due to a pre-existing relationship, faces a new credit constraint because the small institution with which she has a relationship cannot meet her demands, and larger institutions, would still consider her business too risky. This problem is especially acute if the business has not acquired valuable assets or reliable accounts receivable against which larger financial institutions can provide credit.

6.4 ENFORCEMENT OF MICRO CREDIT CONTRACTS

Contract enforcement is critical for credit markets to function efficiently. In Uganda, issues such as fraud, corruption, and case backlog make enforcing contracts through courts of law difficult. There has been an attempt to ensure speedy resolution of commercial disputes by creating a court that specifically handles commercial and contractual disputes. However, because micro credit loans involve small amounts of money, legal costs and the time spent in litigation make judicial enforcement counterproductive. There are proposals to establish a small claims court that will handle disputes involving small amounts of money and use flexible procedures that will allow parties to represent themselves. This approach would solve the problem of case backlog and high litigation costs, but will not address the problem of debtors who deliberately choose to default because they have no substantial assets that creditors can attach. Therefore, micro credit lenders use one or more of the following measures to enforce contracts.

6.4.1 Peer/Group Enforcement

Group guarantee loans shift the task of contractual enforcement to borrowers because, as stated in the literature, they are able to use tools like social pressure to ensure compliance with contractual obligations. Group members mobilize their peers to pay their loan installments, attend group meetings, and comply with loan obligations. To minimize the risk of paying for defaulting members, some respondents

indicated that during formation of a group, they do not accept individuals who are known to be dishonest or who have a history of default.

The fact that group members usually conduct business in the same location, such as a market or reside in the same area, reduces default rates because of the expected consequences, such as pressure from peers, social stigma, confiscation of assets, and withdrawal of cooperation. Usually defaulters relocate to other areas. However, group members may assist their peers to repay a loan if they are experiencing some legitimate difficulty. Some respondents stated that if a group member is unable to repay because of illness, family problems, or some other disability, they will assist her.

6.4.2 Social Pressure

Micro credit lenders also use social pressure to ensure compliance with contractual obligations, including naming and shaming defaulters, threats of denying credit to the defaulter's peers in the group and the members of the area where defaulter conducts business or lives. Lenders often elicit the support of local leaders to pressure defaulting borrowers to repay their loans. The fear of embarrassment and harassment by lenders' agents forces borrowers to find alternative sources of money if the business cannot generate sufficient returns. Such sources include friends, family, and proceeds from the sale of personal and household items.

6.4.3 The Incentive of Contingent Renewal of Credit

Contingent renewal of credit is a commonly used incentive for loan repayment. Micro credit loans are structured as small loans with shorter repayment periods so that borrowers who successfully repay a loan are eligible for future credit. The majority of micro enterprises that obtain formal credit use it to finance working capital, which creates a constant need for capital injection. Therefore, borrowers always have an incentive to comply with contractual obligations, and other loan conditions, so as to be able to obtain more credit. A borrower who complies with the loan contract terms and repays on schedule is not only eligible for more credit, but also enjoys the benefits of reduced loan processing time and, sometimes, a lower interest rate and reduced charges. This is because lenders have a reduced perception of risk for repeat borrowers. At Centenary bank, it takes up to five days to process a loan for a first time borrower, and the interest payable is 22% per annum, and a monitoring fee of 2% of the value of the loan is also charged. On the other

hand, a repeat borrower’s loan is processed within a day, and although the interest rate is the same as that charged to a first time borrower, the monitoring fee is reduced to 0.5% of the value of the loan.

Table 13: Contingent Credit Incentives for Various Micro Credit Lenders

Lender	Incentives
Centenary Bank	-Shorter processing period for subsequent loans -Reduced loan monitoring fee
Post Bank	-Top up loans
PRIDE MDI	-Larger loan amounts than initial loan -Longer repayment period
Success Microfinance (U) Ltd	-Larger loan amounts than initial loan -Longer repayment period
FAULU (U) Ltd	-Larger loan amounts than initial loan -Shorter processing period for subsequent loans

In his article on Contracting, Enforcement and Efficiency,²⁵⁷ Avner Greif argues that although neoclassical economics suggests that legal enforcement is required to foster efficient anonymous exchange, other forms of contract enforcement institutions, such as reputation and personal trust, can also govern exchange relations efficiently. According to Greif, there is no uniquely optimal combination of contract enforcement institutions. What is critical is that for a given economic situation, an enforcement institution is a function of economic, social, cultural, and political factors. Therefore, in the context of micro credit contracts, the enforcement mechanisms should facilitate mutually beneficial exchange.

Peer/ group enforcement not only shifts the enforcement function from the lender to the borrower, but also deters borrowers from engaging in opportunistic behavior, such as simply reneging on their obligation to repay a loan. This reduces the risk of default for the lender and increases the lender’s willingness to provide credit. In addition, the cost of credit is reduced for the borrowers within the

257 Avner Greif, Contracting, *Enforcement and Efficiency: Beyond The Law*, 239, in Annual World Bank Conference on Development Economics (Michael Bruno & Boris Pleskovic ed. 1997).

group, who do not have to repay the loans of defaulters. However, there are some inherent weaknesses in peer/group enforcement that hurt borrowers in a way that legal enforcement does not. For example, legal enforcement recognizes that even when a borrower defaults, she still has some rights, and, therefore, her personal belongings and means of livelihood cannot be taken away by the creditor. The manner in which loan defaulters are treated and their property seized is an issue that has not been factored into current micro credit contractual arrangements. This problem is exacerbated by a weak consumer protection environment and by the fact that the majority of micro credit lenders are not regulated.

CHAPTER SEVEN

7.0 MICRO CREDIT: INNOVATIVE LENDING AND PERSISTENT ACCESS TO CREDIT BARRIERS

In Chapter 6, I discussed the methods used by micro lenders to screen, monitor and enforce repayment of loans. These measures are primarily intended to minimize the effects of information asymmetry and moral hazard, and thus ease the costs of credit for both lenders and borrowers. Establishing a better mechanism to obtain information about loan applicants and to enforce repayment of loans, should increase willingness to lend. In addition, the lending methods should improve access to credit for borrowers who would otherwise not be able to obtain credit. However, as I will demonstrate in this chapter, some factors still hinder access to micro credit despite the adoption of “innovative” lending methods.

7.1 THE CHANGING NATURE OF MICRO CREDIT LENDERS AND LENDING METHODS

The historical development of Uganda’s micro credit providers is mixed. Some lenders started out as informal credit groups and subsequently became formal or semi-formal institutions. On the other hand, some lenders have no informal historical roots. Irrespective of how they were established, the manner in which the micro credit lenders operate has implications for micro enterprise access to credit. While philanthropic and social objectives were an integral part of micro credit delivery, today the majority of micro lenders operate as fully fledged commercial enterprises.²⁵⁸ Chapter 4 contains a discussion of the historical development of micro credit in Uganda. Although microfinance has gained prominence over the last decade or so, the concept is not new and has roots in informal credit delivery mechanisms that exist in various parts of the world. These credit delivery mechanisms use what some scholars refer to as “non-market institutions” such as reputation and social pressure to enforce contracts²⁵⁹ because of the inadequate enforcement mechanisms available in most low income countries. As Avner Greif points out, informal institutions can efficiently support commercial exchange, particularly in the absence of formal ones.²⁶⁰

258 Marguerite S. Robinson, *The Microfinance Revolution: Sustainable Finance For The Poor* (2001).

259 Timothy Besley, *Nonmarket Institutions for Credit and Risk Sharing in Low- Income Countries*, 9 *Journal of Economic Perspectives* 115 (1995).

260 Avner Greif, *Contracting, Enforcement and Efficiency: Beyond the Law*, in *Annual World Bank Conference on Development Economics*, 239 (Michael Bruno & Boris Pleskovic ed., 1997).

However, as microfinance institutions evolve, their methods of lending have also gradually changed to reflect the changing nature of their business. As a result, micro lenders have gradually adopted hybrid lending methods that combine informal and formal methods of lending and that increasingly lean towards the formal. For example, group lending's key feature is using collateral substitutes such as forced savings and joint liability. However, some micro lenders such as Centenary bank do not provide credit on group basis, while others such as Commercial Microfinance were at the this research was conducted, gradually phasing out group loans because of operational and market constraints.²⁶¹ A large number of micro lenders that maintain group lending have added variations to its structure, including collateral requirements, which increase costs of credit for those who are unable to cope with the changes. While this transformation is taking place on the part of micro lenders, micro enterprises have largely remained the same. As noted in Chapter 5, the majority operate as informally established sole proprietorships with no substantial assets and poor record keeping. This extrication between the lenders and the borrowers increases costs of credit for the latter. Therefore, it is no surprise that lack of collateral was a major reason for failure to obtain credit.²⁶²

The changes occurring in the microfinance sector, particularly the transition from philanthropic and social enterprises to self-sustaining financial institutions, is largely considered a positive one. However, some costs are associated with this change. Borrowers that are unable to keep pace with these changes will find themselves increasingly unable to obtain credit from these lenders or limited to alternative sources, including informal credit.

7.2 NEGATIVE PERCEPTIONS ABOUT THE SCREENING PROCESS.

In the absence of a formal mechanism for obtaining information about borrowers, micro credit lenders use informal means to screen loan applicants. In addition, because micro enterprises operate informally, evaluation of loan applications is done using informal means. The methods of information gathering used by lenders include obtaining information about a loan applicant from their peers, business associates and neighbors. However, informal screening methods provide fertile ground for

²⁶¹ Group lending is considered inefficient because it is time consuming, involves high operational costs and yet the per capita volumes are very low. In addition, commercial microfinance essentially operates in urban areas and the fluid nature of their customers makes group lending an unsuitable mechanism.

²⁶² In Chapter 5, I reported that only 204 out of the 602 respondents indicated that they had applied for a loan. Of the 204, 48 reported that they had been denied credit, and 25 out of the 48 gave lack of collateral as the reason. In addition, for the 318 respondents who stated that they did not use formal credit to finance their businesses, lack of collateral was the third most cited reason for the inability to use formal credit.

exploiting borrowers. Loan officers take advantage of borrowers to extort bribes or to demand favors. If the borrowers do not comply, they might risk receiving a negative assessment. Micro lending institutions are aware of this problem and have notices in their banking halls that discourage payment of bribes to loan officers. However, this practice is difficult to police.

Some respondents felt that the information gathering tools used by micro lenders were intrusive and left no room for privacy. They also reported feeling that lenders “spy” on borrowers and may gather information that they could use against borrowers. In addition, some lending methods, such as group lending, are by design public transactions but some borrowers were not comfortable operating in the public sphere. However, the respondents who expressed concern about the screening process as a deterrent to accessing formal credit were in the minority, and the majority of respondents did not seem to be bothered by the process. Some respondents felt that payment of bribes to loan officers was such a common practice that it was considered normal to factor the amount of the bribe into the loan. Obviously such respondents did not consider a bribe to be a cost. However, for some people, it may be a cost that deters them from applying for a loan.

Arguably micro lending should incorporate formal screening processes to minimize the problems associated with informal screening. However, the presence or absence of formal screening is a much more complex phenomenon that involves legal and institutional capabilities. In addition, formal screening processes would not necessarily make it easier to access credit because they may introduce costs and distortions that cannot be reasonably anticipated ex-ante. In these circumstances, informal screening which occasionally may be combined with formal screening methods, are the only practical tools. Increasing client education and adopting institutional codes of good practice may help alleviate some of the problems associated with informal screening. Some self-regulatory bodies such as the Association of Microfinance Finance Institutions encourage their members to adopt codes of good practice, such as client charters in which they commit themselves to treat clients fairly, and to disclose all material information to their clients. Some commentators have also argued that the public nature of micro credit transactions has some positive aspects, including preventing fraud by loan officers.²⁶³

7.3 HARSH EXPECTED CONSEQUENCES OF DEFAULT.

Moral hazard in credit markets exists because of weaknesses in contract enforcement mechanisms. The situation is exacerbated when borrowers have no substantial assets that a lender could attach in the event of default. The measures adopted by micro lenders to minimize moral hazard include group or peer enforcement, the incentive of contingent credit, social pressure, threats, and ostracism. To the extent that these measures reduce the risk of default, lenders costs are reduced. However, like any other enforcement tool, the measures are not perfect and do not entirely eliminate the possibility of default. There is a school of thought that although group lending improves repayment rates, the pressure to repay loans can increase costs for poor and vulnerable borrowers who are faced with difficulties beyond their control.²⁶⁴

Fear of default and its consequences was the second most cited factor for not obtaining credit. Some of these respondents were probed further during interviews, and the explanations they gave revealed something much broader. The inability to repay a loan may result from endogenous or exogenous factors. Endogenous factors exist when either the borrower has not used maximum effort to ensure that the project succeeds and the loan is repaid, or simply chooses to default on the loan. Exogenous factors are external shocks suffered by the borrower that negatively impact his ability to repay the loan. These shocks may not be unique to the borrower and people in similar circumstances may experience them too, such as political insecurity, prolonged drought, and floods.

Creditors can often distinguish between exogenous and endogenous default, and may apply different sanctions accordingly. For example, if default is caused by external shocks, the loan may be restructured, and this approach is commonly used by commercial banks. However, the majority of micro credit lenders apply the same sanctions irrespective of the nature of the default. This practice partly explains the high repayment rates of micro credit institutions. Sanctions such as denial of future credit, social pressure, and ostracism are indiscriminate tools used to force repayment. Many micro credit institutions are also aware that their clients businesses may not be able to generate the income to repay the loan and that clients look to other sources, such as friends and family members, to repay loans. This may discourage borrowing, particularly for those who are able to determine

264 Richard Montgomery, *Disciplining or Protecting the Poor? Avoiding the Social Costs of Peer Pressure in Micro Credit Schemes*, 8 *Journal of International Development* 289 (1996).

ex ante that if the project fails, they would not be able to repay the loan from other sources and would therefore face severe sanctions.

Micro lenders' inability to respond to shocks that may affect the ability of a borrower to repay a loan may be a way of reducing the lender's risk, but it could significantly deter borrowing. Some lenders reported that they were aware that borrowers face difficulty repaying loans. However, they still demand the scheduled repayment, rather than restructure the loan because they are aware that most borrowers can repay a loan from sources other than their business income. Some micro lenders also expressed fear that borrowers may abuse the practice of restructuring loans.

Another factor related to default is the lender's response may send signals to potential borrowers that discourage them from accessing credit. Several respondents felt that lenders "take advantage of loans to seize borrowers' assets". This belief may stem from a lack of understanding of the collateral attachment process, particularly when lenders do so by private treaty rather than through the courts. In addition, lenders take advantage of borrowers' ignorance to use unlawful and extra legal means to seize collateral. This problem has become so pervasive that some local leaders are beginning to express concern about it.

Kyeyune Explains why MFIs are unpopular²⁶⁵

Confiscation of people's property after failing to pay back loans has made microfinance institutions (MFIs) unpopular, Eng. Ian Kyeyune, the chairman of Wakiso district, has observed.

7.4 COST OF CREDIT

Information asymmetry and moral hazard not only affect the efficient performance of credit markets, but also increase the cost of credit. The uncertainties faced by lenders force them to increase interest rates to compensate for the risk that some bad borrowers may end up in their pool of debtors. Micro credit contracts are designed to minimize the problems of information asymmetry and moral hazard, and this goal has been partially achieved. Group lending and member based lending institutions have narrowed the information gap between lenders and borrowers as well as enabled the use of enforcement tools such as peer pressure and social sanctions. As a result, micro lenders generally report high repayment rates as a factor which has led to increased willingness to lend and ease of access to credit

265 The New Vision Newspaper, February 26, 2007. (Available at <http://www.newvision.co.ug/detail.php?mainNewsCategoryId=8&newsCategoryId=220&newsId=551194>).

markets for borrowers. However, the cost of credit may remain high for other reasons. Out of the 359 respondents who had never obtained a loan, 94 stated that high interest rates and other loan expenses were a major hindrance to obtaining credit, while 84 feared default and its consequences, which are also linked to the cost of credit.

Various factors affect the cost of credit, including both micro and macro. An analysis of interest rates and other charges of micro credit institutions indicates some degree of consistency across the board — on average about 36% per annum. However, when compared to other financial institutions such as commercial banks, two factors stand out. The first is that interest rates and other charges are generally high, and, therefore, the cost of credit in Uganda is high. This factor may be attributed to macro-economic issues such as lenders' risk perception of the Uganda market, limited competition, poor infrastructure, inflation, and high risks associated with weak contract enforcement and inadequate creditor information. The second factor is that interest rates and charges of micro credit institutions are much higher than those of commercial banks. Interest rates charged by commercial banks range between 16–24% per annum while microfinance institutions charge between 36–40% per annum.

Although the risk profile of borrowers from commercial banks is different from that of microfinance clients, the wide margin between interest rates charged by commercial banks and by micro lenders indicates that certain factors force micro lenders to charge higher rates, which translates into costly micro credit. This may be because of costs associated with microfinance delivery, such as the need to hire several credit officers to train, monitor clients and to follow up on loan repayments. Moreover, the nature of microfinance clients does not favor automation, which would significantly reduce administrative costs. A CGAP study sought to establish why interest rates charged by microfinance institutions were so high and found that:

“The problem is that administrative costs are inevitably higher for tiny micro lending than for normal bank lending.... Consequently, interest rates in sustainable microfinance institutions (MFIs) have to be substantially higher than the rates charged on normal bank loans. The majority of MFIs' interest income goes to pay operating costs (salaries and other administrative costs), which are about 60 percent of total MFI costs.... We do not find evidence suggesting any widespread pattern of borrower exploitation by abusive MFI interest rates. We do find strong empirical support for the proposition that operating costs are much higher for tiny microloans than for normal bank loans,

so sustainable interest rates for microloans have to be significantly higher than normal bank interest rates....”²⁶⁶

The issue of interest rates charged by microfinance institutions has attracted global attention.²⁶⁷ There is a school of thought that as microfinance institutions transform from social and philanthropic entities that rely on subsidies, to profitable organizations, charging high interest rates is inevitable in order for them to become sustainable.²⁶⁸ This school of thought is based on the notion that high interest rates do not hurt poor borrowers since in most low income countries, they borrow from money lenders at exorbitant rates that are often above 100%.²⁶⁹ In addition, that if charging high interest rates makes microfinance institutions sustainable in the long run and less reliant on subsidies, it enhances the welfare of borrowers because they are able to reach out to more clients.²⁷⁰ However, high interest rates and the drive towards commercialization have a negative impact on the social objectives of microfinance and increase costs for certain categories of borrowers.

Micro lenders may also be unable to access cheap capital for onward lending. Some lenders reported that they obtain capital from internally generated funds, including membership fees, but this is insufficient to sustain their lending business so they often have to borrow from commercial banks, which is an expensive source of loanable funds. Some micro lenders are able to access funds from donor agencies and from subsidized government credit channeled through the microfinance support center. However, access to subsidized credit has not translated into cheaper credit for borrowers because of the high operational costs of microfinance institutions.²⁷¹

266 Richard Rosenberg, Adrian Gonzales & Sushma Narain, *The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates*, 1-21 (CGAP Occasional Paper No. 15, 2009) (Available at http://www.cgap.org/gm/document-1.9.9534/OP15_rev.pdf).

267 Robert Cull, Asli Demirguc-Kunt & Jonathan Morduch, *Microfinance Meets the Market*, 23 *Journal of Economic Perspectives* 167 (2009); Richard Rosenberg, Adrian Gonzales & Sushma Narain, *The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates*, (CGAP Occasional Paper No. 15, 2009) (Available at http://www.cgap.org/gm/document-1.9.9534/OP15_rev.pdf).

268 Robert Cull, Asli Demirguc-Kunt, and Jonathan Morduch, *Microfinance Meets the Market*, 23 *Journal of Economic Perspectives* 167, 170-2 (2009).

269 *Id.* at 171.

270 *Id.* at 168-9; Richard Rosenberg *et al.*, *supra* note 266, at 1 (arguing that “sustainable microfinance providers can continue to serve their clients without needing ongoing infusions of subsidies, and can fund exponential growth of services for new clients by tapping commercial sources, including deposits from the public.”)

271 Charles K. Byanyima, Executive Director Microfinance Support Center. He cites high operational costs, poor management skills, lack of infrastructure, particularly IT, as factors that have contributed to the high cost of credit delivery in Uganda. He further states that the microfinance support center, the government, and some donor agencies are aware of this problem and have attempted to provide capacity building and infrastructure support to microfinance institutions.

The other explanation for the high cost of micro credit is that the lending methods used by micro lenders do not entirely eliminate the problems of adverse selection and moral hazard. As discussed in Chapter 6, group lending may narrow the information gap between lenders and borrowers, but there are cases where bad or risky borrowers are able to join a group. Such borrowers may have provided false information, which other group members are unable to detect, or their peers may have deliberately let them in, despite knowledge of adverse information about them. Therefore, the lenders' risk perception remains unchanged, and they are only willing to provide credit at a rate that compensates for the perceived risk.

Some lending methods such as group lending also increase the cost of credit because of joint liability. Some new research is beginning to emerge that shows that it might be more valuable to redesign micro credit contracts by eliminating joint liability, and instead retaining the group structure for purposes of screening and monitoring borrowers. A field experiment conducted in the Philippines,²⁷² where joint liability was removed from one group of lenders and retained in another, showed that there were no significant variations in the repayment rates of both groups. However, the group with no joint liability registered an increase in new clients. The authors further stated that there are other mechanisms, such as the incentive of contingent credit, could eliminate problems like moral hazard that joint liability is meant to solve.

7.5 THE LIMITATIONS OF CONTINGENT CREDIT.

Contingent credit is generally heralded as an excellent credit repayment incentive. It reduces lenders' exposure risk because loans are structured in such a way that small initial loans are given out to first time borrowers, and only those who successfully repay are eligible for future credit. For the borrowers, the benefits include access to future credit, longer loan repayment periods and shorter processing periods for subsequent loans. As long as borrowers are aware that they are only eligible for more credit if they successfully repay a previous loan, they will be less willing to engage in opportunistic behavior. Furthermore, in cases where default may be due to external shocks, borrowers will try to minimize the shock's impact on their ability to repay. In cases of group loans, the incentive creates willingness among group members to repay the loans of defaulting group members. The

²⁷² Xavier Gine & Dean S. Karlan, *Group Versus Individual Liability: A Field Experiment in the Philippines* (World Bank Policy Research Working Paper No.4008 (2006) (Available at <http://go.worldbank.org/VQA6356VS0>).

incentive is only effective when contingent debt is valuable to the borrower, and when the cost of repaying an existing loan, as well as paying for defaulters, is less than the expected benefit of a future loan.

For are some categories of borrowers, the structure of contingent loans diminishes the benefit of accessing such a loan. Most micro lenders, particularly for group loans, have a pre-determined “loan menu” indicating the amount that a first time borrower is eligible to borrow and the incremental loans for subsequent loan cycles. However, for those borrowers that require large amounts of capital as opposed to small incremental loans, the structure of contingent loans does not suit their needs.

How to solve the problem of lack of flexibility in structuring contingent loans to accommodate borrowers’ varying credit needs remains unclear. Lenders lack information about borrowers that would enable them to vary loan amounts so that borrowers are eligible to borrow depending on their needs. Borrowers who require larger loans may be required to pay higher interest rates or to put up collateral, which could put those borrowers in a worse off position. If lenders had more information, they would be able to structure loans differently. However, in the absence of such information, they adopt mechanisms like contingent credit that limit their exposure. It may not suit the needs of some borrowers, but that may be a cost that cannot be avoided.

7.6 THE COSTS AND BENEFITS OF GROUP HOMOGENEITY.

One of the fundamental principles of group loans is that the borrowers who obtain credit through groups have some common characteristics and common needs. The common characteristics include belonging to a low income bracket and ownership of informal, opaque businesses with no substantial assets. The common need may be to use the group to gain entry into the credit market. Using their common characteristics, micro lenders have devised means of providing credit to these categories of borrowers. Most micro lenders have a pre-determined “loan menu” which indicates the minimum a first time borrower is eligible to borrow and successive amounts for each stage of repeat borrowing. See table 4 in Chapter three. How these amounts are determined is not clear, although there is evidence that they are periodically revised. A pre-determined “loan menu” may satisfy the needs of most group members, but not all. Some respondents stated that they were discouraged by the small amounts of loans made available without taking

into account individual credit needs. Structuring group loans according to the needs of individual group members pros and cons. The most advanced argument in favor of this draws on the practice in commercial banks.

In the last 5 years, commercial banks in Uganda have developed and aggressively marketed a consumer loan product commonly called a salary loan that is an unsecured and made available to any borrower who is employed and earns a monthly income. Banks treat borrowers from a particular employer as a group, and the evaluation process considers factors such as the nature of the employer, the total wage bill, and the employer's commitment to remit the employees installment payments to the lender. However, in determining how much they will lend, banks assess the borrower's individual characteristics and needs. Arguably micro lenders can use the group structure to obtain information about borrowers, that ensures that they are able to distinguish between borrowers and provide credit based on the individual assessment of each borrower as opposed to a pre-determined "loan menu". But this argument does not take into account the fact that commercial banks have access to more information about salaried employees than micro lenders have about their clients. In addition, salary loans carry an implicit guarantee that, for as long as the borrower has a job, the employer undertakes to remit installment payments to the lender. There is no such equivalent with loans to micro businesses.

The second argument in favor of varying group loan amounts is that it does not alter the structure of group loans. Some scholars have argued that a group structure in which individual members borrow different amounts of loans does not necessarily impose higher costs and risks on the individual who borrows the least amount. Evidence is beginning to emerge that joint liability is not the determinant factor of repayment rates in group loans. Rather, factors such as group cohesion, the incentive of contingent credit, and the threat of social sanctions are more effective tools against moral hazard. In addition, even if group members borrowed the same amount of money, the risk is not necessarily evenly spread among them. This is because, as discussed in Chapter 6, the group structure does not entirely eliminate the problem of adverse selection. Some group members sometimes disregard adverse information about a member if in their judgment it will not affect his or her ability to repay the loan. Sometimes it is merely a case of doing one a favor in expectation of the same at a future date. Such adverse information includes multiple borrowing, and false declaration of assets and income. In such cases, a group member, who is a multiple borrower or who falsely declared assets, imposes a higher risk on other borrowers within the group even if he or she

obtained the same amount of money as everybody else. Therefore, a group structure with varying loan amounts is feasible.

On the basis of the above, one could argue that the inability to screen borrowers according to need as opposed to providing a pre-determined loan menu, is a weakness in the group loan structure, and that lenders should focus on individual characteristics of borrowers rather than group characteristics. However, this approach may be unrealistic because microlenders operate in an environment of imperfect information. In addition, the administrative procedures involved in creating and monitoring different loan structures may increase the cost of credit and make everybody in the group worse off.

7.7 EXPLOITATION AND HARASSMENT OF BORROWERS

Conventional wisdom suggests that in credit markets that are characterized by weak contractual enforcement, borrowers have an incentive to default, which increases lenders risks. However, a weak contractual environment hurts both parties to a credit transaction, and, in some circumstances, may hurt the borrower more. The issue that the literature on microfinance has not addressed is that, in addition to the borrower paying a high price for the risks associated with moral hazard, the borrower is prone to exploitation and abuse by the creditor. The exploitation may be in form of the nature of information that the creditor chooses to give to the borrower, and the abuse usually occurs when the creditor uses extra legal means to recover from a defaulting borrower, in which case the bankruptcy and insolvency protections are often abused.

Some respondents stated that they were not keen to use formal credit because of the manner in which lenders treat borrowers, particularly the manner in which borrowers seize defaulters' assets, as well as the use of threats and intimidation to force repayment of loans. Below is a debt collection incident that was reported in one of the local newspapers.

Ishaka debt collectors seize baby²⁷³

Debt collectors from Ishaka Women Trust Bank branch on Tuesday morning took away a four-month-old baby after its mother run away from home. The team had gone to Harriet's home to collect the sh140,000 loan but took away the baby after the mother delayed to return. "Before I went to look for the money, I told them to wait.

273 Chris Ahimbisibwe, *Ishaka debt collectors seize baby*, The New Vision, 3 March 2006. (Available at <http://www.newvision.co.ug/detail.php?mainNewsCategoryId=8&newsCategoryId=18&newsId=485110>).

When i returned, my baby was nowhere to be seen,” Harriet told Bushenyi Police. Bushenyi Police chief Michael Ssebuliba said the baby was found with a customer at the bank. The Police has summoned the bank manager.

Exploitation and harassment of borrowers, as well as other extra legal actions that lenders use to recover loans from defaulting borrowers, point to a failure of both formal and informal institutions to adequately protect both parties to a credit transaction. As earlier discussed, that in the absence of formal institutions to govern contractual relations, microfinance relies on informal institutions to extend credit to the economically active poor in low income countries. However, the informal institutions are primarily designed to constrain debtor's opportunistic behavior of debtors. To the extent that they achieve this goal, the informal institutions embody the principles of a creditor rights system that is embedded in the formal institutions that govern creditor contractual relations. However, the informal institutions, are inadequate in some respects, particularly on issues of consumer protection, property and individual rights protection, as well as the protections available to debtors in bankruptcy. Negative publicity and competition may help to constrain bad behavior of creditors. In addition, social norms, such as industry codes of good practice, may persuade lenders who are interested in the long term sustainability of their institutions, to adopt practices that treat their clients fairly. In addition, as microfinance institutions gradually adopt the practices of more formal lending institutions, such as commercial banks (a factor discussed in 7.1), they may abandon some negative practices associated with the manner in which they conduct their business.

7.8 BUSINESS ENVIRONMENT UNCERTAINTIES

In his article on contract enforcement in Ghana, Marcel Fafchamps²⁷⁴ discusses problems that cause businesses to fail to comply with contractual obligations, and thus force them to renegotiate contracts or pass on the risks to another party as a coping mechanism. Some of the problems faced by businesses include poor infrastructure, unreliable communication, and unpredictable weather patterns. These difficulties may cause delay or failure to supply goods and services. In this study, some of the respondents stated that they operated in an environment where they faced various risks that may affect their ability to generate sufficient revenue to repay their loans. Some of the risks cited were fire, floods, high transport costs, prolonged dry seasons that affect the agricultural output of their suppliers, the outbreak of disease and

274 Marcel Fafchamps, *The Enforcement of Commercial Contracts in Ghana*, 24 *World Development* 427 (1996).

other public health risks that may force their markets to be closed. Such business uncertainties, combined with inflexible micro credit contracts that do not allow restructuring loans, discourage using formal credit. Insurance is one way of minimizing the uncertainties, but it is unaffordable for micro enterprises and increases the costs of credit. To minimize risks associated with business uncertainties, proprietors of some businesses opt to finance them from personal funds as well as re-investing profits.

Innovative lending methods used by micro lenders have helped to alleviate the access to credit problem. However, the environment in which small businesses operate, as well as the uncertainties faced by small businesses that are not credit related, are an integral part of the factors that affect the capacity to use formal credit. Therefore, it is also critical to resolve business environment related constraints, because the higher the business uncertainties, the more likely that a risk averse borrower will not seek credit.

7.9 LIMITATIONS IN CHOICE OF LENDER

The manner in which the majority of microfinance institutions operate creates an access problem for borrowers. With the exception of microfinance deposit taking institutions and a few microfinance institutions that have branches in various parts of the country, most micro credit institutions have one branch and provide services within a particular geographical area. The inability to open branches can be attributed to several factors including, inadequate capital and high transaction costs as a result of poor infrastructure. Therefore, the majority of institutions limit their operations to a particular area which allows them to take advantage of local knowledge and to monitor their clients efficiently. This factor limits borrowers' freedom to choose where to borrow. Freedom of choice and competition are drivers of market efficiency. However, borrowers in major cities and urban centers are less likely to experience this problem than borrowers in rural areas due to the concentration of micro credit institutions in urban areas.

In addition, the minimum amounts that first time borrowers are eligible to borrow are not suitable for all first time borrowers. Although minimum amounts vary from one institution to another, individual borrowers may not be able to freely choose a lender because of the lender's geographical operational restrictions as well as the preferences of fellow group members. These factors may force a borrower to seek credit from an institution other than the preferred lender or to opt out all together.

Conclusion

Access to credit is a major global concern, particularly in low income countries where market inefficiencies increase the cost of credit for those enterprises that need external financing. Remedial measures initially focused on direct state intervention in credit markets through state owned financial institutions or credit subsidization programs, such as credit guarantees. It is largely undisputed that this mechanism did not achieve the desired results. With the support of bilateral and multilateral agencies, many governments adopted the alternative approach of strengthening the market structures necessary for an efficient credit market. This included improving credit information systems such as credit registries, streamlining property ownership through law reform, improving the capacity of land registries, and strengthening courts to improve contract enforcement. However, these measures are slow, because law reform and institutional change does not happen overnight. Additionally, the reforms often suffered setbacks as a result of cultural or other jurisdiction-specific constraints.

The other mechanism used to improve access to credit in low income countries is microfinance, which uses “innovative lending” strategies to overcome the problems of adverse selection and moral hazard. Various studies, as discussed in Chapter two, have shown that these lending methods have minimized these problems. As a result, microfinance has transformed the lives of individuals, communities, and small businesses by improving access to credit. However, access to micro credit remains a challenge for many economic players, including micro enterprises. This study sought to establish why, despite measures to improve access to credit through “innovative lending”, micro enterprises remain reluctant to use micro credit to finance their businesses.

Micro credit providers in Uganda are diverse, including formal, semi-formal, and informal institutions. In this study, analysis was restricted to formal and semi-formal institutions, including the only commercial bank involved in micro lending, deposit-taking microfinance institutions, non-deposit taking microfinance institutions, and savings and credit cooperatives. The products and services offered by the various lenders are similar across the board and they fall broadly into the categories of consumer and small business loans. The latter are used primarily to finance working capital. Methods used to screen and monitor borrowers are largely informal, such as group/peer screening, information gathering from business colleagues, and knowledge obtained through repeated interaction and relationships

built over time with loan officers. These lending methods reflect the nature of Uganda's credit market and are designed to mitigate the risks of inadequate creditor information and weak contract enforcement. Therefore, group lending and individual asset-based lending are predominantly used. In addition, the strategy of providing credit within a specific geographical location, such as within a 30 kilometer radius of the micro credit institution, is designed to mitigate the effects of information asymmetry and ensure effective monitoring of borrowers.

The study involved 602 micro enterprises from various regions in Uganda including Kampala, the eastern, western, and northern regions of the country. As discussed earlier, the majority of micro enterprises operate as unregistered, sole proprietorships that are primarily engaged in retail business. Therefore, credit needs are largely for purposes of financing working capital. Most micro enterprises have fewer than five employees, an indicator that unlike SMEs, which have the capacity to create a significant proportion of private sector jobs, micro enterprises' contribution to the labor market is largely limited to self employment. In countries such as Uganda, micro enterprises play a bigger economic role than is perhaps understood or acknowledged. They operate in the informal sector and, therefore, their contribution to economic activity and employment is difficult to measure and document. However, they are very visible, and undisputedly micro enterprises, particularly those engaged in retail business are the biggest source of non-agricultural self-employment and economic activity in Uganda.

Start-up capital for most micro enterprises is usually mobilized from informal sources, such as personal savings, funds from friends and family members, and trade credit. This factor explains why they operate on a small scale and without substantial assets. For micro enterprises that use formal credit, microfinance institutions rather than commercial banks are the major source of credit. This is because of "innovative lending" methods in microfinance that make it easier for micro enterprises to gain entry into the credit market. The nature of micro enterprises (informally established, lacking substantial assets, requiring small loans which necessitate intensive monitoring) makes them ineligible for commercial bank credit for which lending is primarily asset-based.

Analyzing factors that affect micro enterprises' access to credit-- location (urban versus rural), age (recently established versus newly established), size, ownership (male, female or jointly owned) - did not reveal any consistent patterns. A vast body of literature suggests greater use of alternatives to formal credit, like trade

credit in undeveloped credit markets such as Uganda. This scholarship is accurate when the question is posed as: “How do you finance your business?” However, it does not explain the need for credit among small businesses. Many business enterprises have a real need for external credit but are, for various reasons, unable to obtain it. Of the 602 micro enterprises in this study, only 204 indicated that they had applied for a loan, while 398 indicated that they had never applied for a loan. An analysis of their reasons revealed that only 43 micro enterprises did not need credit, 94 reported that high interest rates and other costs of borrowing affected their ability to obtain credit, and 84 indicated that they did not borrow because of fear of default and its consequences.

Although “innovative lending” strategies used in microfinance attempt to minimize the problems of adverse selection and moral hazard, thereby improving access to micro credit in low income countries, some shortcomings are associated with the lending methods that increase costs of credit for some borrowers. The reliance on informal screening tools may be the only available option, in the absence of institutions that facilitate formal screening, and the fact that most micro enterprises operate informally. However, informal screening is prone to abuse and exploitation, and is considered intrusive by some borrowers. The lending methods used may improve access to credit, but they also have disadvantages. Group lending provides an entry point to the credit markets for borrowers who have neither credit history, nor valuable assets to use as collateral. However, the lack of flexibility in structuring group loans, joint liability, and social pressure may increase costs of credit for some borrowers.

Monitoring and enforcement of micro credit contracts relies heavily on informal mechanisms, such as peer monitoring, relationship building through repeated transactions, and social pressure. These methods reduce lenders’ exposure and filter out risky borrowers. However, peer monitoring in group lending contracts is time consuming, and small incremental loans with shorter repayment periods are unsuitable for some borrowers. In addition, the evolving nature of micro credit and the limitations of the informal institutions that support micro credit contracts have implications for access to credit. As discussed in 7.1, as micro lenders gradually adopt formal lending tools, the costs of credit for some borrowers increase. Another weakness is the failure of informal institutions that support micro credit to incorporate consumer protection and other tools that constrain bad creditor behavior.

Therefore, although there is overwhelming evidence of the need for formal

credit among micro enterprises, for the reasons stated here, and discussed in more detail in Chapter 7, they remain reluctant to use formal credit. This explains why “innovative” lending has not crowded out informal finance, or is doing so, at much slower pace than anticipated. This has negative implications for the finance-growth nexus, because as discussed in Chapter 2, although businesses can be financed from either formal or informal sources, the capacity of informal credit to efficiently allocate resources and to operate beyond network effects is limited.

APPENDIX I: COMMERCIAL BANKS IN UGANDA AS OF DECEMBER 2009

Bank	No. of Outlets	Assets (Ugshs)	Deposits (Ugshs)	Advances (Ushs)
Crane Bank (Local)	11	531,526,519,000	418,768,766,000	240,383,914,000
Orient Bank (Foreign)	11	262,363,877,000	199,567,444,000	122,769,906,000
Tropical Bank (Foreign)	7	203,275,866,000	106,284,478,000	55,288,697,000
Centenary Bank (Local)	36	582,668,799,000	443,443,926,000	343,148,123,000
Bank of Africa (Foreign)	16	223,737,000,000	726,873,000,000	486,036,000,000
Barclays Bank (Foreign)	51	996,898,000,000	726,873,000,000	486,036,000,000
National Bank of Commerce (Foreign)	2	22,786,279,000	9,577,508,000	7,698,744,000
DFCU Bank Ltd (Foreign)	23	611,821,000,000	346,683,000,000	326,299,000,000
Cairo International Bank (Foreign)	2	62,238,569,000	48,677,276,000	25,359,451,000
Kenya Commercial Bank (Foreign)	11	115,746,525,000	69,180,309,000	47,233,464,000
Housing Finance Bank (Local)	12	259,323,250,000	109,411,797,000	180,604,122,000

Standard Chartered Bank (Foreign)	11	1,242,548,215,000	780,123,618,000	572,966,515,000
Stanbic Bank (Foreign)	66	1,321,510,864,000	1,072,857,718,000	477,590,312,000
Bank of Baroda (Foreign)	7	386,545,213,000	271,701,594,000	121,150,063,,000
Citi Bank (Foreign)	1	479,578,459,000	293,223,974,000	92,298,250,000
Diamond Trust Bank (Foreign)	14	208,115,224,000	176,009,714,000	118,932,855,000
United Bank of Africa (Foreign)	5	76,508,598,000	66,550,666,000	10,439,762,000
Global Trust Bank (U) Ltd (Foreign)	7	40,271,267,000	24,526,029,000	14,918,435,000
Equity Bank (U) Ltd (Foreign)	13	154,740,775,601	71,568,612,233	82,812,563,951
Ecobank (U) Ltd (Foreign)	8	63,494,616,000	45,537,642,000	23,484,744,000
FINA Bank (U) Ltd (Foreign)	5	n/a	n/a	n/a

Source: Crane Bank Ltd, Audited Financial Statements for the year ended 31 December 2009, in, The New Vision Newspaper, Monday 22 March 2010 at p.11; Orient Bank Ltd, Financial Statements for the Year Ended 31 December 2009, in, The New Vision Newspaper, Monday 15 March 2010 at p.54; Tropical Bank Statement of Financial Position as at 31 December 2009, in, The New Vision Newspaper, Tuesday 27 April 2010 at p.45; Centenary Rural Development Bank Extracts of Financial Statements for the year ended 31 December 2009, in, The Daily Monitor Newspaper, Wednesday 7 April 2010 at P.36; Bank of Africa (U) Ltd Financial Statement Extracts for the year

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APPENDIX II: CREDIT INSTITUTIONS AND MICROFINANCE DEPOSIT INSTITUTIONS IN UGANDA AS OF DECEMBER 2009

A CREDIT INSTITUTIONS

Name	Date Established	Branches	Assets Ugshs.	Deposits Ugshs.	Loans & Advances Ugshs.
Mercantile Credit Bank Ltd	1986	1	7,726,702,177	5,112,059,752	3,486,857,800
Capital Finance Corporation Ltd	1995	1	n/a	n/a	n/a
Post Bank (U) Ltd	2002	29	77,678,564,420	63,307,142,580	6,930,047,263

Source:http://www.bou.or.ug/bouwebsite/opencms/bou/supervision/financial_institutions.html; Mercantile Credit Bank Ltd Statement of Financial Position for the year ended 31 December 2009, in, The New Vision Newspaper, Thursday 22 April 2010 at p33; PostBank Uganda Ltd Income statement for the year ended 31 December 2007, in, The New Vision Newspaper, Vol. 23 No.087, Wednesday 30 April 2008 at p.12;

B MICROFINANCE DEPOSIT INSTITUTIONS

Name	Date Established	Branches	Assets Ugshs.	Deposits Ugshs.	Loans & Advances Ugshs.
FINCA (U) Ltd	1992	22	66,083,274,000	8,913,575,000	47,805,118,000
PRIDE MDI	1995	29	50,971,943,838	13,772,783,000	34,623,560,913
Uganda Finance Trust Ltd	1984	26	37,384,717,000	13,820,274,000	27,543,467,000

Source:http://www.bou.or.ug/bouwebsite/opencms/bou/supervision/financial_institutions.html; PRIDE Microfinance Ltd (MDI), Financial Statements Extracts for the Year Ended December 2009, in, The New Vision Newspaper, Tuesday 27 April 2010 at p44; Uganda Finance Trust Ltd (MDI) Financial Statements for the Year ended 31 December 2009, in, The New Vision Newspaper, Monday 19 April 2010 at p.54; FINCA UGANDA Ltd(MDI) Income Statement for the Year ended 31 December 2009, in, The Daily Monitor Newspaper, Tuesday 6 April 2010 at p.38;

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THE DESIGN OF MICRO CREDIT CONTRACTS AND MICRO ENTERPRISE FINANCE IN UGANDA

DR WINIFRED TARINYEBA-KIRYABWIRE

Studies have shown that the negative effects of credit market inefficiencies are most felt by smaller firms. Therefore, in countries such as Uganda, where micro enterprises are at the bottom of the economic pyramid, moral hazards and adverse selection severely affect their ability to access formal credit hence limiting their growth potential. Microfinance has been heralded for its use of innovative lending methods to improve access to credit. The last decade has witnessed an unprecedented increase in the outreach of micro lending institutions and the development of financial products suited to the needs of the economically active poor, who often, are unable to obtain credit from mainstream financial institutions. This book analyzes the law and economics theories on access to credit and enterprise finance and based on case studies in Uganda, presents empirical findings of the promise and limits of contractual innovations in micro credit.

Dr Winifred Tarinyeba-Kiryabwire is a lecturer and acting Head of Department of Public and Comparative Law at the Faculty of Law Makerere University where she teaches the Law of Business Associations, Corporate Governance and Corporate Finance Law. She holds a Doctor of Science of Law degree (JSD) and Master of Science of Law degree (JSM) from Stanford University, USA as well as a Master of Laws degree (LLM) from Cambridge University, UK; a Postgraduate diploma in Legal Practice (PGDLP) from the Law Development Center; a Bachelor of Laws degree (LLB) from Makerere University. She is a Commonwealth and Fulbright Scholar and has received several fellowships including the Robert S. McNamara Fellowship of the World Bank, Fellow of the Stanford Program in International Legal Studies and the Cambridge Commonwealth Society Fellowship.

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